

Economic Substance Regulations in the UAE



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IN A NUTSHELL

Economic Substance Regulations (“ESR”) were introduced by the UAE Government in 2019. ESR impacts all entities licensed in the UAE whether on the mainland or in the free zones. Penalties for non-compliance with ESR range from AED 10,000 to AED 50,000.

There are two reporting requirements under ESR - (1) filing of an annual Notification; and (2) filing of an annual Return. These have to be filed for financial years commencing on or after 1 January 2019.

Recently, many Regulatory Authorities in the UAE have announced 30 June 2020 as the deadline for Notification for the first financial year under ESR Rules. Deadline information for Notification is awaited from other Regulatory Authorities.

The Annual Return has to be filed within twelve months from the financial year-end.

CONTENTS

What is esr and why is it introduced in the UAE?	3
What is BEPS? What is the relationship between ESR and BEPS?	3
What are the obligations of businesses under ESR?	4
How can we demonstrate economic substance if we are engaged in one or more Relevant Activities?.....	4
Who are the Regulatory Authorities?	4
What are the “Relevant Activities?”	5
What are the deadlines? What changed now?	5
What should the businesses do from a reporting perspective?	6
Do these Notifications and Returns have to be audited?	6
What are the outcomes of non-compliance?	6
How Nishe can help?.....	7



WHAT IS ESR AND WHY IS IT INTRODUCED IN THE UAE?



The objective of ESR is to ensure that the UAE entities which earn income from "Relevant Activities" as defined in the ESR are able to demonstrate that they have economic substance in the UAE.

The ESR has been enacted primarily as a result of two developments in recent years:

- (1) The blacklisting of the UAE by European Union as a non-cooperative tax jurisdiction; and
- (2) The UAE's commitment as a member of the OECD Inclusive Framework on Base Erosion and Profit Shifting ("BEPS").

WHAT IS BEPS? WHAT IS THE RELATIONSHIP BETWEEN ESR AND BEPS?

BEPS project was undertaken by OECD mainly to address the concerns that large multinational groups are shifting their profits around the world using various tax loopholes available in order to (legally) take advantage of the low/no tax jurisdictions and thereby reduce the overall tax expense for the group.

BEPS project also focused on the concerns that the legacy tax rules are not compatible with the new technology-driven business model which has upended many traditional business practices and introduced new products and new ways of delivering products.

Both these issues potentially resulted in: (1) many multi-national groups not contributing their 'fair share' of taxes; and (2) inequity between countries in collecting and benefiting from the tax incomes.

The outcome of the BEPS project is a 15-point multi-pronged action plan which was published by OECD in 2013. BEPS has taken the international tax world by storm in recent years. Many countries have signed up and there are sweeping changes happening including changes to domestic tax rules and international tax treaties, increased reporting requirements, significantly increased cooperation between tax authorities in different countries etc.

ESR requirements have been imposed only on some countries which are considered as at higher risk of having licensed entities without economic substance, i.e. purely for the purpose of tax avoidance. Other countries that have had to introduce ESR include Bahrain, Bermuda, Seychelles, Bahamas, British Virgin Islands etc.,

The objective of ESR is to ensure that the profits earned by entities licensed by these jurisdictions reflect the real economic activity within the jurisdictions. This is why ESR has focused only on certain activities which are considered at risk (i.e. the Relevant Activities).

Relevant Activities are essentially those which deal with “geographically mobile” income.



WHAT ARE THE OBLIGATIONS OF BUSINESSES UNDER ESR?

Under the Economic Substance Regulations, an entity licensed in the UAE is required to:

- (1) Submit an annual notification to the respective Regulatory Authority IF it has performed any of the “Relevant Activities” as defined in the Regulations; and
- (2) Subsequently, file an annual return to substantiate the entity’s economic substance in the UAE IF it has generated income during the year from the Relevant Activities. Entities which earn income from Relevant Activities in a financial period also have to meet the economic substance test.

HOW CAN WE DEMONSTRATE ECONOMIC SUBSTANCE IF WE ARE ENGAGED IN ONE OR MORE RELEVANT ACTIVITIES?

ESR provides guidance on how to meet the economic substance test. Broadly, this involves assessing and proving that, in relation to the Relevant Activity,

- ▶ The Core Income Generating Activities (“CIGA”) are carried out in the UAE;
- ▶ The entity is directed and managed in the UAE; and
- ▶ There are adequate expenditure, qualified full-time employees and physical assets in the UAE.

WHO ARE THE REGULATORY AUTHORITIES?

The Regulatory Authorities for the purpose broadly are:

- ▶ The UAE Ministry of Finance for the onshore entities; and
- ▶ The respective Free zone authority for entities registered in the free zones.
- ▶ In some cases, other authorities are also designated as such (for e.g. Central Bank in respect of Banking Business).

The UAE Ministry of Finance is the Competent Authority responsible for overseeing the ESR compliance.

WHAT ARE THE “RELEVANT ACTIVITIES?”

Relevant Activities are:

- ▶ 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

Definitions and details on Relevant Activities are provided in the Regulations and related guides.



WHAT ARE THE DEADLINES? WHAT CHANGED NOW?

The Return filing deadlines have already been announced some time ago. But until recently, there had not been any firm announcements of deadline with respect to the Notification. Further, the related guides and forms/templates were also largely unavailable.

However, recently, various Free Zone authorities have announced 30 June 2020 as the deadline for filing first Notification. The UAE Ministry of Finance has also announced on press that 30 June 2020 is the deadline communicated to all regulators for Notification. The related notification forms also seem to be now in place in a number of Free Zones.

However, do note that some Regulatory Authorities may have a different deadline (quite likely earlier than 30 June 2020). Hence you are advised to check with the respective Regulatory Authority on the deadline. And certain other Regulatory Authorities have not yet announced any deadlines.

WHAT SHOULD THE BUSINESSES DO FROM A REPORTING PERSPECTIVE?

All the entities licensed in the UAE, without fail, must:

(1) Undertake an assessment of:

(1.1) Whether the entity performs any of the “Relevant Activities” as defined by the ESR Rules; and

(1.2) Whether it has earned income in 2019 from the Relevant Activities.

(2) If the answer to 1.1 is yes, then perform an Economic Substance Notification to the designated Regulatory Authority by the relevant deadline (mostly 30 June 2020 for the first financial year);

(3) If the answer to 1.2 is also yes, then

(3.1) Perform a detailed assessment to demonstrate adequate economic substance in the UAE; and

(3.2) File Economic Substance Return to the Relevant Authority by the deadline (within 12 months from the end of the financial year).

Such Notifications and Returns will have to be submitted on an annual basis.

DO THESE NOTIFICATIONS AND RETURNS HAVE TO BE AUDITED?

No.

WHAT ARE THE OUTCOMES OF NON-COMPLIANCE?

Non-compliance could mean non-compliance with the reporting requirements and/or failing the economic substance test.

The financial penalties for non-compliance for both are severe. The financial penalties for failure and inaccuracies in reporting range from AED 10,000 to AED 50,000 while the financial penalties for failing economic substance test range from AED 10,000 up to AED 300,000 for repeated failures.

Further, there are provisions in ESR allowing the Ministry of Finance to exchange information about entities who fail the economic substance test with other relevant Foreign Competent Authorities.

There are also provisions for cancelling or non-renewal of licenses for non-compliance.

HOW NISHE CAN HELP?

If you need assistance in complying with ESR, please contact Nishe.

We can provide the following services in relation to ESR:

- ▶ Assessing whether your business is undertaking any Relevant Activity;
- ▶ Preparing and filing the Notification with the respective Regulatory Authority;
- ▶ Assessing whether economic substance requirements are met;
- ▶ Identifying gaps in meeting economic substance requirements, if any, and providing recommendations to fill the gaps identified; and
- ▶ Preparing and filing the Economic Substance Return.

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