



UAE issues additional guidance on economic substance regulations – First notification effective from 01 January 2020.

Summary

Further to the recent issuance of [Cabinet of Ministers Resolution No. 31 of 2019 concerning economic substance regulations](#) ('**ES regulations**'), the UAE Ministry of Finance has, on 11 September 2019, issued additional guidance for the implementation of ES regulations in the UAE (referred as [Ministerial Decision No. 215 for the year 2019 on the issuance of directives for the implementation of the provisions of the Cabinet Decision No. 31 of 2019](#)) ('**additional guidance**').

The issuance of additional guidance may be due to the results [published](#) by the OECD on 'no or only nominal tax jurisdictions'. On 23 July 2019 (i.e., one month after the UAE ES regulations were published in the public domain), the OECD Forum on Harmful Tax Practices (FHTP) concluded that UAE's legal framework was in line with the standard but with one technical point outstanding. In this respect, the FHTP mentioned that the UAE has committed to make further legislative changes and the law is now "in the process of being amended".

As detailed in our [previous alert](#), UAE entities carrying out certain 'Relevant Activities' will need to report compliance with the ES regulations (linked to state core income generating activities ('**CIGA**'), direction and management, 'adequate' people, assets, premises and expenditure tests, in the UAE) on an annual basis, and where they are unable to demonstrate economic substance, they would be subject to penalties (and even revocation of the license, if non-compliance is repeated). Therefore, each entity would need to evaluate the need to fulfil substance requirements, and/or consider restructuring of operations.

As per the ES regulations, the Cabinet of Ministers/ the UAE Ministry of Finance were expected to issue the following resolutions for further guidance to implement ES regulations in the UAE:

- (a) determining the Regulatory Authority that shall regulate compliance with the ES regulations; and
- (b) how the economic substance test may be met, including any expression used for the purpose of that test, and also including the meaning of "adequate".



Given the UAE Ministry of Finance has released additional guidance on how the economic substance test may be met, it can be expected that the Cabinet of Ministers will shortly issue a resolution determining the Regulatory Authorities for the purposes of the ES regulations. It is expected that the Regulatory Authorities could include federal, emirate, free zone and other authorities that issue licenses, however, this is yet to be confirmed.

The additional guidance provides the following key clarifications:

- the effective date for **reporting purposes** (for a period effective from 30 April 2019) to be twelve (12) months from the end of the financial year commencing on or after 01 January 2019;
- **notification requirement** to be effective from 01 January 2020;
- **exemption threshold** for entities with at least **51% direct or indirect ownership** by the government;
- **adequate number of board meetings** depends on the level of Relevant Activity carried out, however **at least one (1) meeting** should be held annually;
- terms “adequate” and “appropriate” will be dependent on the nature and level of Relevant Activity, and Licensee should **maintain “sufficient” records to demonstrate compliance**;
- outsourcing **must not be used to circumvent** the economic substance test;
- use of timesheets suggested as medium for verifying “adequate” employee test;
- headquarters business criterion is **not dependent on the entity’s position in the group structure** but on the nature of services provided; and
- the Regulatory Authority should **adopt a strict yet pragmatic approach** to the applicability of economic substance test.

Detailed analysis of the additional guidance follows in this document. We hope you find the same useful.



Clarifications provided in the “additional guidance” in comparison with the “ES regulations”

Topics	ES regulations	Additional guidance
	<i>Issued on 30 April 2019</i>	<i>Issued on 11 September 2019</i>
Definition of Licensee	Article 1 of the ES regulations states that a Licensee is a natural or juridical person licensed by the competent licensing authority.	Article 3(3.1) of the additional guidance states that a Licensee is considered licensed by virtue of holding a commercial license, certificate of incorporation or other forms of permit. <i>Therefore, temporary permits issued by the Dubai Municipality and other federal authorities for undertaking a Relevant Activity could be in-scope for the purposes of this regulation, as opposed to only the license(s) issued by the Department of Economic Development and the various free zone authorities.</i>
Limited scope companies	Article 3(1) of the ES regulations states that the provisions shall apply to a Licensee that carries out any Relevant Activity.	Article 3(3.1) of the additional guidance states that every Licensee that carries on a Relevant Activity and derives an income therefrom in the UAE must meet the economic substance test. <i>Therefore, if a Licensee carrying out Relevant Activity does not derive income in the UAE in a financial year, it seems that such entity may not be required to meet the economic substance test in that financial year. However, it would be required to submit a notification within the timelines stipulated by the Regulatory Authority.</i> <i>Further, under the Cayman Islands regulations¹, a Relevant Entity that carries on a Relevant Activity, but which has no relevant income is not obliged to meet the requirements of the economic substance test as set out in section 4 of the ES Law.</i> <i>The said entity will still, however, be required to satisfy its notification and reporting obligations under the ES Law (i.e., the report filed will be a ‘nil’ return). Therefore, until additional clarification is issued, one may be able to draw inference from the Cayman Islands regulations in order to determine the approach under the UAE ES regulations.</i>

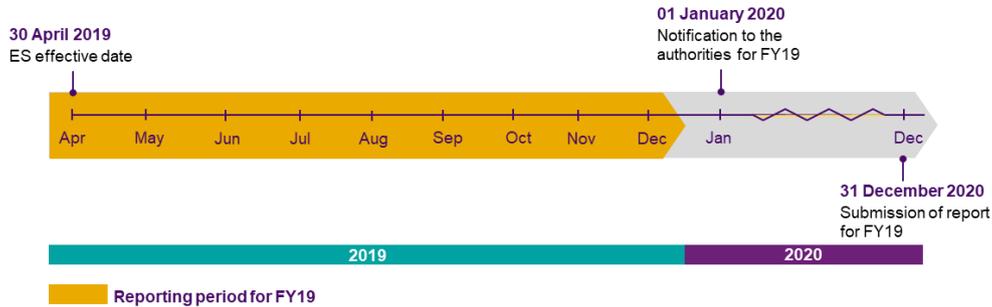
¹ Cayman Islands Guidance on Economic Substance for Geographically Mobile Activities v2.0



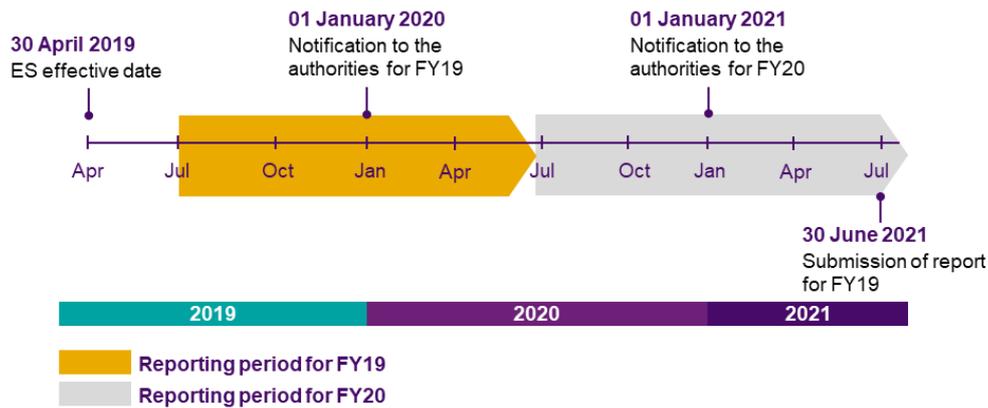
Exempt companies	Article 3(2) of the ES regulations states that the provisions of the Resolution shall not apply to any commercial company in which the Government has any direct or indirect ownership in its share capital.	Article 3(3.2) of the additional guidance states that companies in which the Government has at least 51% direct or indirect ownership in its shareholding are not subject to the regulations. <i>Therefore, 50:50 joint ventures by the government, associate interest and diluted (below 51%) indirect shareholding entities will not qualify for the exemption under the regulations.</i>
Notification timelines	Article 8 of the ES regulations states that the notification shall be made at the time specified and, in the form, and the manner approved by the Regulatory Authority.	Article 4(4.2) of the additional guidance states that the Licensee shall, with effect from 01 January 2020 , submit a notification to the Regulatory Authority. <i>UAE entities need to determine their obligations and be ready to submit notifications by 01 January 2020. Please note that the notification form is yet to be specified (i.e., hard-copy form, online, etc.)</i>
Reporting timelines	Every in-scope entity is required to comply with the economic substance regulations effective from 30 April 2019. Article 8 of the ES regulations states that every in-scope entity shall, no later than twelve (12) months after the last day of the end of each Financial Year of the Licensee , prepare and submit to the Regulatory Authority a report.	Article 4(4.2) of the additional guidance states that every in-scope entity shall, within twelve (12) months of the end of each Financial Year of a Licensee commencing on or after 01 January 2019 , submit a report to the Regulatory Authority. <i>Therefore, UAE entities carrying out a Relevant Activity and deriving income therefrom in the UAE and having a 01 January 2019 FY commencement date will be required to submit a report by 31 December 2020.</i>



Example 1: UAE entity which carries on a Relevant Activity and derives an income therefrom in the UAE, with a financial year from 01 January 2019 to 31 December 2019, will have to adhere to the following timelines:



Example 2: UAE entity which carries on a Relevant Activity and derives an income therefrom in the UAE, with a financial year from 01 July 2019 to 30 June 2020, will have to adhere to the following timelines:



CIGA list

Article 5 of the ES regulations outlines the list of activities that **must be conducted by a Licensee** in the State.

Article 4(4.3) of the additional guidance states that the **list of CIGA is not exhaustive**.

Therefore, a Licensee should assess and report the key activities performed by the entity as opposed to relying only on the CIGAs listed under the ES regulations.



Board meetings	Article 6 of the ES regulations states that the Licensee's board of directors should meet in the State at an adequate frequency .	Article 4(4.3) of the additional guidance states that adequate number of meetings is dependent on the level of Relevant Activity being carried out by a Licensee. It is expected that at least one (1) meeting is held in a Financial Year in the UAE . Further, consideration must also be given to meeting requirements prescribed under other applicable laws in the UAE (example, federal company law, DIFC laws, Central Bank circulars, etc). The additional guidance also clarifies that if an entity is managed by an individual (general manager or CEO) rather than a board, then the board meeting requirements would suffice to the extent of the individual.
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Clarifications provided in the additional guidance

Meaning of “adequate” and “appropriate”	Article 6 of the ES regulations requires entities to have adequate employees, physical assets and operating expenditure. As per Article 4(4.3)(g) of the additional guidance, the terms “adequate” and “appropriate” will be dependent on the nature and level of Relevant Activity carried out by a Licensee. Every Licensee will have to ensure that it maintains sufficient records to demonstrate the adequacy and appropriateness of the resources utilized and expenditures incurred . The Regulatory Authority may consider timesheets or other evidences when assessing whether a Licensee has an adequate number of employees, and relevant comparable statistics such as average revenue per employee. <i>The guidance published by the Crown Dependencies (Jersey, Guernsey, Isle of Man) explain that employees may include persons who are legally employed by the company, who are not employed but work for the company, owners, managers and directors but does not include interns/apprentices.</i>
Entities with directors only (No employees)	As per Article 4(4.3)(g) of the additional guidance, if the director performs CIGA in addition to performing their fiduciary duties as a director of the entity, and thereby reduce or even eliminate the need for full-time employees, then the Regulatory Authority may consider that as evidence of the CIGA being performed by adequate employees in the UAE.



Premises	<p>Article 4(4.3)(g) of the additional guidance clarifies that Premises can include offices or other forms of business premises depending on the nature of Relevant Activity (such as warehouses or facilities). <i>Therefore, a Licensee with a flexi-desk/ shared desk may need to prove that it has adequate premises, suitable for conducting its Relevant Activity.</i></p>
Outsourcing	<p>As per Article 4(4.3)(g) of the additional guidance, a Licensee may outsource the economic substance requirements to a related company.</p> <p><i>Therefore, groups that have common resources may meet the economic substance requirements, as long as they are able to demonstrate adequate employees, assets and expenditure for each Relevant Activity. Groups would need to document this through appropriate contractual agreements. Similar positions have been taken by Cayman Islands, Jersey, Guernsey and a few others.</i></p> <p>Further, as an anti-avoidance measure, the additional guidance states that outsourcing must not be used to circumvent the economic substance test.</p>
Headquarters business	<p>The additional guidance clarifies that an entity which carries on headquarters business is not dependent on its position in the group structure.</p> <p>It is entirely dependent on the services it provides to other companies in the group, whether parent company or subsidiaries. Therefore, headquarters license issued by Department of Economic Development or various free zone authorities is not the only criteria to determine whether the entity carries on a Relevant Activity.</p>
Functions of Regulatory Authority	<p>Article 6 of the additional guidance outlines the functions of a Regulatory Authority:</p> <ul style="list-style-type: none">• shall receive, review, hold, store and disseminate as required all documentation, records and information that any Licensee is required to submit to the Regulatory Authority;• shall ensure that all documentation is received in a timely manner and complete;• shall promptly follow-up with the Licensee in the event of any delay or information is discovered to be incorrect or incomplete;• serve a notice on a Licensee for further information;• enter a Licensee's premises to obtain necessary information;• impose penalties;• make determination as to whether a Licensee meets the economic substance test;• shall supply copies of all reports and information provided to it by Licensees to the Ministry of Finance. <p>The additional guidance clarifies that the Regulatory Authority should adopt a strict yet pragmatic approach to the applicability of economic substance test. This is a clarification that provides guidance on the possible approach that the Regulatory Authority should take while reviewing the reports.</p>



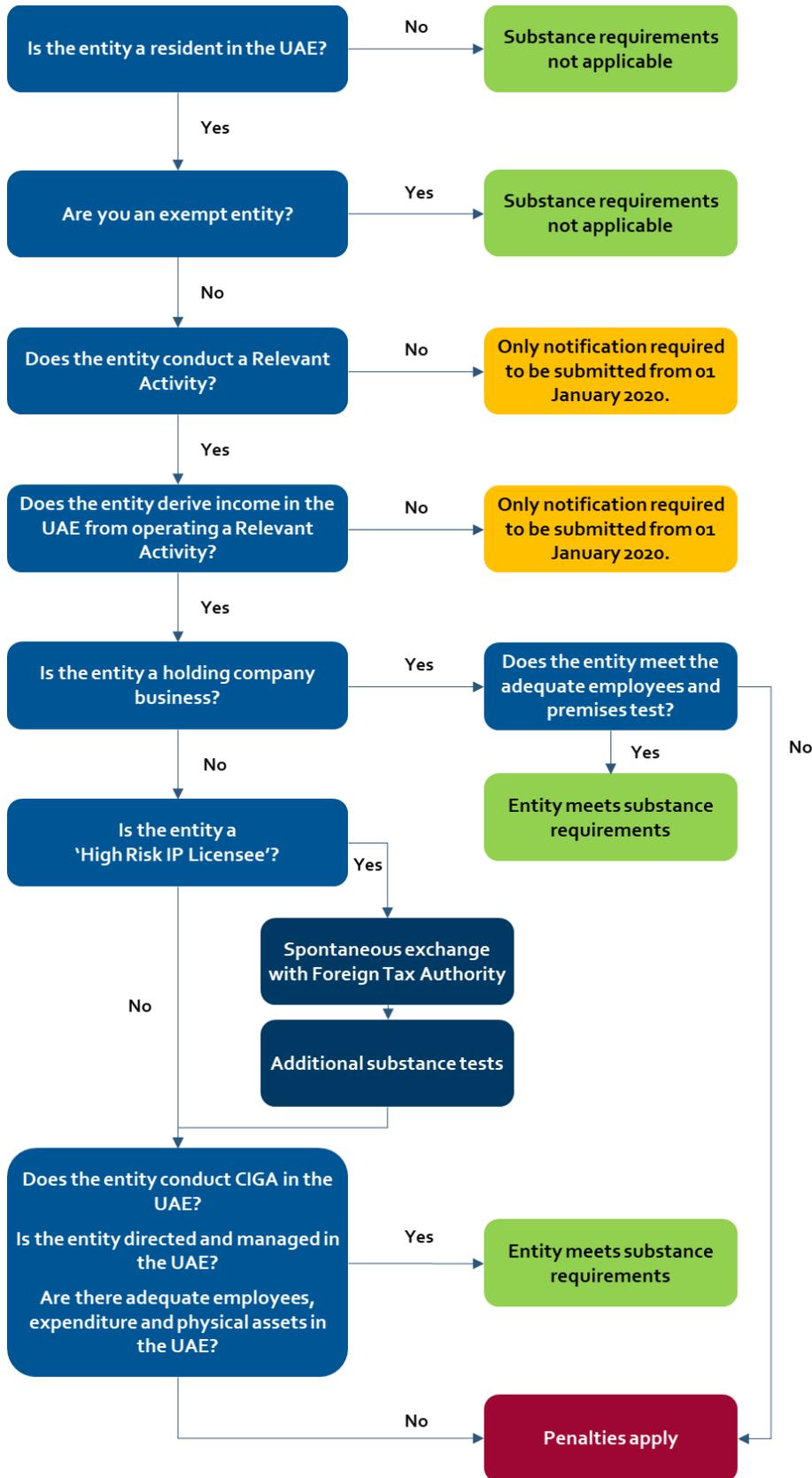
Minimum cap on penalties	<p>The ES regulations included a minimum cap on penalties of AED 10,000 (in the first year) and AED 50,000 (in subsequent years).</p> <p>Although not explicitly stated but the wording of the guidance alludes to the removal of minimum cap on penalties. For instance, the additional guidance now states that the Regulatory Authority shall impose an administrative penalty not exceeding AED 50,000 (in the first year) and AED 300,000 (in subsequent years).</p>
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Some learnings from ES regulations issued by overseas jurisdictions

Liquidation or otherwise ceasing to carry out Relevant Activities	<p>Currently, the ES regulations and additional guidance is silent with respect to UAE entities carrying on a Relevant Activity that is liquidated or under liquidation process during a financial year.</p> <p><i>Please note that the Cayman Islands regulations provides guidance for entities carrying on a Relevant Activity that is liquidated or under liquidation process during a financial year:</i></p> <ul style="list-style-type: none">• <i>where Relevant Activities continue during the liquidation process, the liquidators (or equivalent) must ensure that the entity continues to satisfy all its obligations under the economic substance law.</i>• <i>the entity is not required to satisfy the economic substance test after it ceases to carry on relevant activities.</i>• <i>notification and reporting will not be required with respect to any period during which the entity is no longer carrying on relevant activities that generate relevant income.</i>• <i>an entity (which carried on a Relevant Activity) which is finally dissolved or completes winding up is not required to:</i><ul style="list-style-type: none">○ <i>comply with the notification obligation on the economic substance portal before it is possible to register for notification purposes, or</i>○ <i>to report for the purposes of the economic substance law before reporting is possible.</i>• <i>Any liquidators (or equivalent) or other representatives of an entity who were responsible for the liquidation, winding up or dissolution of the relevant entity have duties to maintain the relevant entity's records and to respond to the Regulatory Authority's information requirements under the economic substance law for six years after final dissolution.</i>
Transitional period	<p><i>Bermuda, Bahamas, Cayman Islands and a few other jurisdictions allow entities already in existence i.e. conducting business activities prior to the date of commencement of economic substance regulations, a transitional period of six months to commence compliance with economic substance requirements. Entities formed on or after that date should be in compliance from day one.</i></p> <p><i>Such provisions are absent in the UAE ES regulations.</i></p>



How to determine the obligations of an entity?





Next steps

As previously mentioned, with the commitment from the OECD Forum on Harmful Tax Practices (FHTP) to constantly monitor the effectiveness of jurisdictions' mechanisms to ensure compliance with the standard in practice, and the subsequent issuance of additional guidance and early notification requirement, UAE's intent to implement the ES regulations is evident.

While the regulations should not impact UAE headquartered businesses and others with genuine operations in the UAE, there will be reporting and compliance requirements to manage. Nevertheless, all UAE entities should consider the following actions (priority) in order to prepare for the requirements as of 01 January 2020:

- Analyse the group structure to identify entities in the UAE and other jurisdictions (like BVI and Cayman Islands) which require compliance with their local economic substance regulations; and
- Determine if the UAE / relevant overseas entities undertake any Relevant Activities.

Further, UAE entities carrying out a Relevant Activity and deriving income therefrom in the UAE should consider the following actions in order to comply with the economic substance requirements:

- Perform a gap assessment to determine the current level of compliance with the requirements;
- Review contracts to understand the outsourcing function provided by third-party contractors;
- Determine remedial options which could include taking steps to inject additional substance or restructure the entity(ies) / business / operations / holdings;
- Review information gathered which is required (under Article 8(4) of the ES regulations) to be submitted to the relevant authorities;
- Undertake a training for key personnel to educate on the economic substance requirements to be complied; and
- Maintain a compliance tracker for the respective in-scope UAE entities.

If you would like our assistance in understanding the specific implications of the same to your business, please feel free to get in touch with us.

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