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Economic Substance Regulations in the UAE

The UAE Government has released the Resolution of the Cabinet of Ministers No. (31) for 2019 concerning Economic Substance Regulations (“ESR”) with effect from 30 April 2019. The Resolution requires that UAE entities carrying on specific categories of licensed activities in the UAE satisfy prescribed economic substance criteria and report annually on compliance. On 11 September 2019, the UAE Ministry of Finance issued Ministerial Decision No. 215 of 2019 containing further guidance on how the ESR may be met.

The provisions of the ESR shall apply to entities that carry out any relevant activity in 9 designated sectors (“Licensee”), including the Free Zones, but shall not apply to any directly or indirectly owned governmental company, authority or body. Licensees that are directly or indirectly at least 51% owned by the Federal or an Emirate Government, or a UAE Government body or authority, are exempted from the ESR. “License” includes a commercial license, a certificate of incorporation or other form of permit required to be procured prior to carrying out relevant activity.

The sectors to adhere to the ESR and considered to be relevant activities thereunder are:

- (1) Banking
- (2) Insurance
- (3) Investment Fund Management
- (4) Lease-Finance
- (5) Headquarters
- (6) Shipping
- (7) Holding Company
- (8) Intellectual Property
- (9) Distribution and Service Centre.

A Licensee must satisfy the criteria to meet the Economic Substance Test in relation to any relevant activity carried on by it. Criteria to be met are

- conducting Core Income-Generating Activity (“CIGA”) in the UAE (explained in respect of each sector specifically in Art. 5 of the ESR) – The list is not exhaustive and applicability is not limited to the listed activities.
- Company Management and decision-making should be undertaken from within the UAE, which means that a board of directors meet in the UAE at an adequate frequency – at least one meeting per financial year – and a quorum of directors being physically present. Moreover, the meetings need to be recorded in written minutes, signed by the directors attending the meetings and kept in the UAE. In case an entity has no board of directors but is managed solely by one manager, the latter need to be present in the UAE when taking key-decisions.
- adequate number of qualified full-time employees in relation to the activity who are physically present in the State
- adequate operational expenditure in the UAE
- adequate physical assets in the UAE.

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What will be considered as adequate or appropriate for each Licensee will be dependent on the nature and level of relevant activity being carried out. A Licensee will have to ensure that it maintains sufficient records to demonstrate the adequacy and appropriateness of the resources utilized and expenditure incurred. It is outlined that it is not the intention of the ESR to impose requirements on businesses to engage more employees than actually required by the business or incur expenditure beyond its needs, provided that the business is engaged in genuine business activity and carrying out a CIGA in the UAE with the employees, expenditures and premises present. The Regulatory Authorities shall take a pragmatic approach when applying the Regulations.

Entities that carries out on more than one relevant activity are required to satisfy the Economic Substance Test for each relevant activity.

The regulatory authority shall be notified annually with the following information:

- whether or not it is carrying on a relevant activity.
- if the entity is carrying on a relevant activity; whether or not all or any part of the entity's gross income is subject to tax in a jurisdiction outside of the UAE, in all cases such entity shall provide the regulatory authority with all information and documentation required.
- the date of the end of its Financial Year.

If a report needs to be prepared, it should be submitted to the regulatory authority no later than twelve (12) months after the last day of the end of each Financial Year, including

- the type of relevant activity conducted
- the amount and type of relevant income, operating expenses and assets
- the location of the place of business
- the number of full-time employees with qualifications
- information showing the Core Income-Generating Activity
- a declaration as to whether or not the Licensee satisfies the Economic Substance Test.

Penalties ranging from AED 10,000 to AED 300,000 shall be imposed for failure to meet the Economic Substance Test or to submit a report or to submit inaccurate information.

Retention of information

While the ESR does not prescribe set period for the retention of information by a Licensee, it is advisable that a Licensee that is required to satisfy the Economic Substance Test in relation to a relevant activity, to retain any relevant information evidencing compliance with the ESR for a period of six years after the end of the financial year, so as to allow such Licensee to address any requests for information that may be received from a regulatory authority during the six years period granted to a regulatory authority to reach its determination.

Outsourcing

Licensees which want to outsource administrative activities may still meet the criteria if their service providers are located within the UAE. The resources of a third-party service provider in the UAE will be taken into consideration to determine the adequacy of a Licensee's resources. The Licensee must be able to demonstrate its ability to supervise the carrying out at all times and remains responsible for ensuring that accurate information is reported to the Regulatory Authority. Outsourcing shall not be done with the objective of circumventing compliance with the Economic Substance Test.

Holding Company Business

Licensees whose activity is restricted to carrying out a Holding Company Business that derives its income from dividends and capital gains only, will be subject to less stringent economic substance requirements, i.e. ensuring compliance with requirements to submit any documents, record or information and maintaining adequate employees and premises for holding and managing the Holding Company Business.

High risk IP related activities

Additional requirements apply if a Licensee carries out “high risk IP related activities”. The regulatory authority shall presume that Licensees engaged in high risk IP related activities have not met the Economic Substance Test, but can be rebutted by a Licensee by demonstrating that it has exercised a high degree of control over the development, exploitation, maintenance, enhancement and protection of the IP asset by an adequate number of full-time employees, with necessary qualifications, who permanently reside and perform their activities in the UAE. Further, they need to show sufficient evidence that decision making is taking place within the UAE.

The recently issued guidance clarifies that the ESR apply to Licensees with financial years commencing on or after 1 January 2019, but a deadline for the first notification/report (due after 1 January 2020) has not yet been set and will be determined by the Regulatory Authorities including the form and manner of the to be submitted notifications/reports. The guidance does not confirm who are the Regulatory Authorities responsible, but it is expected that all Federal, Emirate and Free Zone authorities that issue business licenses are included.

A subsequent guidance may be issued by the Ministry of Finance and/or the Regulatory Authorities to bring further clarifications.

MENA LEGAL will remain attentive to any further developments and keep you informed.

For more information, please contact: info@mena-legal.com

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