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UAE economic substance rules and regulations

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Introduction

Economic substance regulations have been circulating in various forms across several jurisdictions during the last couple of years. They are being introduced across the globe in countries with low or no corporate taxation in order to comply with directives from major regulators based in the European Union, the United States and internationally, which are targeted at so-called 'tax havens'. The primary purpose of the economic substance rules have been to ensure that legal entities established in those countries with low or no corporate taxation (such as the United Arab Emirates, among others) demonstrate that they are engaged in economic activities which meet or exceed a 'economic substance' threshold.



United Arab Emirates – general overview of economic substance

As a member of the Organization for Economic Development and Cooperation (“**OECD**”), the UAE has been cognizant of the developments in OECD and international co-operation against base erosion and profit shifting (“**BEPS**”). The UAE joined the OECD Inclusive Framework on BEPS in May 2018 and committed to introduce minimum standards as part of its admission criteria.

The United Arab Emirates has also paid particular attention to the assessment of the UAE’s taxation and regulatory framework by the European Union Tax Code of Conduct Group.

During 2019, the UAE introduced a number of instruments intended to address the findings of the European Union Tax Code of Conduct Group as well as the OECD’s BEPS Action Plan:

- a. UAE Cabinet of Ministers Resolution No. 31 Of 2019 concerning Economic Substance was introduced on 30 April 2019 (“**Economic Substance Regulations**”);
- b. UAE Cabinet of Ministers Resolution No. 58 of 2019 identifying the relevant Regulatory Authorities responsible for supervision and enforcement of the Regulations (“**Cabinet Resolution**”); and
- c. Ministerial Decision No. 215 for the year 2019 providing guidance on Cabinet Decision No.31 of 2019 was introduced 11 September 2019 (“**Ministerial Decision**”).

The legislative instruments above are intended to apply across the whole of the UAE, including free zones and financial free zones. As of 17 December 2019, the Dubai International Financial Centre (“**DIFC**”), the oldest and most well-established financial free zone in the UAE, confirmed that the DIFC would be subject to the Economic Substance Regulations.

Who is subject to the Economic Substance Regulations?

The Regulations shall apply to all UAE onshore, free zone and offshore entities that carry on a “Relevant Activity” to be within the scope of the Economic Substance Regulations. These entities will include UAE onshore and free zone companies, branches, partnerships, and other UAE business forms (“**Licensees**”). Entities which are directly or indirectly owned 51% or more by the UAE Government (at Federal or Emirate-level) and entities which carry out a Relevant Activity but do not earn income from it are exempt from demonstrating sufficient economic substance.

What are the Relevant Activities under the Economic Substance Regulations?

The ‘Relevant Activities’ are:

- a. insurance;
- b. banking;
- c. lease financing;
- d. investment fund management;
- e. shipping;
- f. holding company;
- g. intellectual property;
- h. company headquarters; and

- i. distribution and service centres.

Who are the Regulatory Authorities?

Each 'Relevant Activity' has its own specific 'Regulatory Authority', as follows:

Banking	UAE Central Bank
Insurance	Insurance Authority
Investment Fund Management	Securities and Commodities Authority
Lease Finance	UAE Central Bank
Headquarters	Ministry of Economy
Holding Company	Ministry of Economy
Shipping	Ministry of Economy
Intellectual Property	Ministry of Economy
Distribution and Service Centre	Ministry of Economy

NB: In the event the business is carried out in a Free Zone or Financial Free Zone, the competent authority or regulator in the respective Free Zone or Financial Free Zone shall be the 'Regulatory Authority'.

What are the economic substance requirements?

For each financial period in which a Licensee earns income from a Relevant Activity, it will need to meet an Economic Substance Test in relation to that activity. The general Economic Substance Test assesses whether a business:

- a. conducts 'core income-generating activities' within the UAE;
- b. directs and manages business from within the UAE;
- c. employs adequate full-time staff in the UAE, or outsources to a UAE-based provider;
- d. incurs adequate operating expenditure in the UAE; and
- e. retains adequate physical assets in the UAE.

Each Regulatory Authority is tasked with making a determination of whether an entity is in compliance with the Economic Substance Test. It is possible that each Regulatory Authority will take differentiated approaches in applying the Economic Substance Test.



Core income-generating activities (“CIGA”)

Each entity that performs any of the Relevant Activities for the purpose of the Economic Substance Regulations will be required to demonstrate that the relevant CIGAs have been undertaken in the UAE. The criteria for the CIGA threshold will vary depending on the relevant activity in question. According to Article 5 of the Economic Substance Regulations, they are as follows:

Relevant Activity	Core Income-Generating Activities
Banking	Raising funds, managing risks, taking hedge positions, providing loans, credit or other financial services to customers, managing capital and preparing reports to investors
Insurance	Predicting and calculating risk, insuring or re-insuring against risk and providing insurance business services to clients; underwriting insurance and reinsurance
Investment Fund Management	Taking decisions on the holding and selling of investments, calculating risk and reserves, taking decisions on currency or interest fluctuation and hedging positions, preparing reports to investors
Lease Finance	Agreeing funding terms, identifying and acquiring assets to be leased, setting terms and duration of any financing or leasing, monitoring and revising agreements, managing risks
Headquarters	Taking relevant management decisions, incurring operating expenditures on behalf of group entities, co-ordinating group activities
Holding Company	All activities related to the business that derives income from dividends and capital gains from the equity interest
Shipping	Managing crew, overhauling and maintaining ships, overseeing and tracking shipping, determining what goods to order and when to deliver, organising and overseeing voyages
Intellectual Property	Taking strategic decisions and managing the principal risks related to (i) development and subsequent exploitation of the intangible asset generating income and (ii) acquisition by third parties and subsequent exploitation and protection of the intangible asset, carrying on the ancillary trading activities through which the intangible assets are exploited leading to the generation of income from third parties
Distribution and Service Centre	Transporting and storing component parts, materials or goods ready for sale, managing inventories, taking orders, providing consulting or other administrative services
Shipping	Managing crew, overhauling and maintaining ships, overseeing and tracking shipping, determining what goods to order and when to deliver, organising and overseeing voyages
Intellectual Property	Taking strategic decisions and managing the principal risks related to (i) development and subsequent exploitation of the intangible asset generating income and (ii) acquisition by third parties and subsequent exploitation and protection of the intangible asset, carrying on the ancillary trading activities through which the intangible assets are exploited leading to the generation of income from third parties
Distribution and Service Centre	Transporting and storing component parts, materials or goods ready for sale, managing inventories, taking orders, providing consulting or other administrative services

Key information regarding CIGA

- a. The Economic Substance Regulations permit the outsourcing of CIGAs to corporate service providers, subject to proper supervision by the entity.
- b. In the case of holding companies (which exclusively hold equity interests in other entities, earn income from dividends or capital gains, and do not carry out any other commercial activity), reduced economic substance requirements apply. They are only required to (i) comply with the submission of documents, records and information to the relevant UAE Regulatory Authority and (ii) employ an adequate number of employees and have adequate premises for holding and managing the business. It is not required to be directed and managed in the UAE, except where this is a requirement of the relevant licensing authority. However, it is important to note that holding companies that generate income from activities other than capital gains and dividends or hold interests assets such as real estate or other investments will be required to comply with the usual Economic Substance Test.
- c. In the case of company headquarters functions, whether or not an entity is deemed to be a company headquarters will not depend on its position in the group but rather on the services it provides to other entities within the group. Licensees providing any of the following services to one or more overseas related entities will fall within the definition:
 - i. the provision of senior management;
 - ii. the assumption or control of material risk for activities carried out by, or assets owned by, any overseas related entity; or
 - iii. the provision of substantive advice in connection with the assumption or control of such risk.



- d. Conceivably, if a UAE based entity establishes a subsidiary overseas and manages that subsidiary from the UAE, theoretically it may be operating a headquarters business and be caught by the legislation. Any company which operates as part of a cross-border group should therefore review their arrangements to ascertain whether they are required to comply with the Economic Substance Rules.
- e. The Economic Substance Rules include distribution and service centres as a single activity; however, for practical purposes they are not necessarily similar business. This ambiguous definition of service centre has the potential to capture many different types of businesses operated by Licensees within the scope of the Economic Substance Rules.
 - i. A service centre is a business providing services to a “connected person” resident outside the UAE in connection with a business outside the UAE. A “connected person” is an entity related through direct or indirect ownership or control, or common control. This definition could potentially capture companies forming part of a group not otherwise captured by the holding company or headquarters definitions.
 - ii. As neither the Economic Substance Rules nor the Ministerial Decision provide any definition or guidance for what sort of “services” are included in this definition it could potentially capture a vast breadth of activities, from a company who provides services to a related party or sister company in its corporate group, including the secondment of employees, information technology services, payroll, human resources, accounting and finance or general business advice.
 - iii. A distribution centre business on the other hand, is a business involved in the acquisition of goods, components or materials from a foreign “connected person” and the sale of such goods, components or materials, which is quite different to a service centre.
- f. The list of core income-generating activities is not exhaustive and there it is possible that other tasks will also be deemed to be core income-generative activities. The general approach of the Regulatory Authorities will be to assess whether the critical functions associated with each Relevant Activity are carried out in the UAE.

Directed and managed

The entity needs to be directed and managed in the UAE with regards to the Relevant Activity. This might include frequent board meetings, quorum of directors who are physically present, minutes of all board meetings being kept in the country, etc. If there is no board, the chief executive officer or the general manager must be physically present in the UAE for key decision making. At this stage, it is unclear whether a Regulatory Authority will permit management personnel to fly in and fly out of the UAE – it would presumably be contingent on the size and nature of the business as well as upon the other physical arrangements of the entity in the UAE.



Adequate staff, expenditure and premises

The entity will need to ensure that it:

- a. employs adequate full-time staff in the UAE, or outsources to a UAE-based provider;
- b. incurs adequate operating expenditure in the UAE; and/or
- c. retains adequate physical assets in the UAE.

The intention of the Economic Substance Regulations is not to force companies to incur business expenditure beyond actual business need, provided that business activity is bona fide and genuine, and the necessary CIGAs are being carried out.

With regards to the retention of adequate physical assets and employees, the entity may consider outsourcing to a third party service provider who will be able to retain employees and the physical assets necessary to comply with the Economic Substance Regulations, however, the relevant Regulatory Authority would still retain final discretion as to whether such measures are 'adequate' in the context of the nature and level of the Relevant Activity being undertaken.

It is important to note that the Economic Substance Regulations do not define the terms 'adequate' or 'appropriate', so the entity must maintain sufficient records to demonstrate the resources utilised and expenditures incurred.

The entity must be able to show and ensure that it has full control over the activity designated to the third party service provider in order to meet economic substance requirements, provided its service providers conduct the activity in the UAE. The Ministerial Decision stipulates that an entity who uses a third-party service provider must demonstrate to the Regulatory Authority that outsourcing is not being done with the objective of circumventing compliance with the Economic Substance Test, however the Ministerial Decision did not specify the circumstances in which outsourcing would be deemed to be circumventing the compliance requirements.





Reporting requirements

Reporting requirements

All Licensees are required to assess whether they undertake a Relevant Activity and if so, notify the relevant Regulatory Authority that has issued its trade licence to demonstrate that it satisfies the economic substance requirements applicable. Only Licensees which are not exempt and undertake a Relevant Activity which they earn income from during a relevant financial year are required to comply with the Economic Substance Regulations and file a report or return with the Regulatory Authority.

The Regulations apply regardless of whether the Licensee belongs to a foreign multinational group. However, a UAE-based distribution, service centre, headquarters function or intellectual property business would only be within the scope of the Regulations if it transacts with foreign group companies. Licensees carrying out these specific activities and who transact only between UAE entities would not be subject to the Economic Substance Test.

The Economic Substance Regulations apply to financial years commencing on or from January 1, 2019. Declarations must be submitted within 12 months from the end of the relevant financial year. For Licensees with a financial year ending on December 31, 2019, a declaration must be made by December 31, 2020. In its declaration, the Licensee must submit an annual report providing details relating to the activity, income, expenses and assets and declaring whether the Economic Substance Test has been met. Each UAE based entity must submit a separate report even if part of a corporate group.

Failure to meet the economic substance test and/or to provide information (or providing inaccurate information) results in significant financial penalties, and ultimately, a deregistration. Additionally, the Regulations provide that the UAE authorities may exchange information about non-compliant UAE-registered companies with the tax authorities in the states where their parent companies and UBO's are resident. In the DIFC, for example, all DIFC entities are required to submit their economic substance notification on the DIFC Portal which is used to communicate with all DIFC-based Licensees, however recently the DIFC confirmed that the original deadline of 31 March 2020 was no longer applicable, without specifying a revised deadline.

The relevant Regulatory Authorities have a period of six years to investigate and assess the compliance of a Licensee with the Economic Substance Regulations during any financial year within this six year period.

Summary

The introduction of Economic Substance Regulations in the UAE has introduced a new set of factors to be assessed by international companies utilising the UAE and UAE based entities as part of their business structure and corporate groups.

As the Economic Substance Regulations are so novel (in a UAE context), it is still unclear and uncertain how many of the provisions contained in the Economic Substance Regulations, the Cabinet Resolution, the Ministerial Decision, and other pronouncements by relevant Regulatory Authorities will be interpreted and applied in practice.

Nevertheless, all entities operating in the UAE should, as a matter warranting immediate attention, review the legislation and its impact on their business, and (i) assess what (if any) Relevant Activities they have performed during the financial period; (ii) assess the income earned or generated (if any) from the Relevant Activity in the relevant period and (iii) begin to implement the necessary steps to bring their entities into compliance.

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