

# inBrief



## UAE Ministry of Finance Issues Guidance on Economic Substance Regulations

By Greg Mayew | 10 October 2019

A previous [inBrief dated 7 July 2019](#) discussed UAE Cabinet Resolution 31 of 2019 Concerning Economic Substance Regulations (the **UAE Economic Substance Regulations** or the **Regulations**).

The UAE Economic Substance Regulations designated the UAE Ministry of Finance as the Competent Authority. One of the responsibilities assigned to the Competent Authority under the Regulations is the issuance of guidance on how the Economic Substance Test (as defined in the Regulations and discussed below) may be met for the purposes of complying with the Regulations. The Ministry of Finance issued such guidance (the **Guidance**)<sup>1</sup> on 11 September 2019.

Article 2.2 of the Guidance explains that the Regulations were issued pursuant to the global standard set by the OECD Forum on Harmful Tax Practices (**FHTP**), which requires companies to have substantial activities in a jurisdiction and also taking into account the standards developed by the European Union (**EU**), specifically the code of conduct developed by the EU Code of Conduct Group (a group responsible for the EU's taxation policy).

### Economic Substance Test

Under the Regulations, a Licensee (as defined below) engaged in a Relevant Activity (see the nine activities listed in bullet points below) must meet an Economic Substance Test in relation to each Relevant Activity carried on by such Licensee. This includes but is not limited to demonstrating that its State Core Income-Generating Activities are carried out in the UAE. The activities that constitute State Core Income-Generating Activities vary for each of the nine Relevant Activities to which the Regulations apply.

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<sup>1</sup> Ministerial Decision No. 215 of 2019 on the Issuance of Directives for the Implementation of the Provisions of Cabinet Decision No. 31 of 2019 Concerning Economic Substance Requirements.

Such Relevant Activities are:

- Banking Businesses
- Insurance Businesses
- Investment Fund Management
- Lease-Finance Businesses
- Headquarters Businesses
- Shipping Businesses
- Holding Company Businesses
- Intellectual Property Businesses
- Distribution and Service Center Businesses

This inBrief highlights thirteen topics covered in the Guidance that may be of interest to businesses affected by the UAE Economic Substance Regulations.

### **1. More than one Regulatory Authority?**

The Regulations contemplate that a yet-to-be designated Regulatory Authority (the Regulatory Authority under the Regulations is different from the Competent Authority) will regulate compliance with the Regulations. The Regulations read as if there will be a single Regulatory Authority for the entire UAE. However, the Guidance, in certain places, contemplates the possibility of more than one Regulatory Authority which raises the question as to whether the Regulatory Authority may be different in each Emirate?

A Cabinet Resolution appointing the Regulatory Authority (or Authorities) is awaited. For stylistic purposes, the remainder of this inBrief will assume a single Regulatory Authority.

### **2. Clarification regarding definition of Licensee**

The Regulations apply to Licensees. Article 1 of the Regulations defines a Licensee as “*any natural or juridical person licensed by the competent licensing authorit/(ies) in the UAE, to carry out a Relevant Activity in the UAE including a Free Zone and a Financial Free Zone.*” The Guidance clarifies that every Licensee “*that carries on a Relevant Activity and derives an income therefrom in the UAE, including a Free Zone or a Financial Free Zone must meet the Economic Substance Test.*” This implies that a Licensee that does not derive any income from a Relevant Activity carried out in the UAE would not be required to meet the Economic Substance Test.

### **3. Majority-owned government owned companies exempt**

Under Article 3(2) of the Regulations, the Regulations do not apply to any commercial company (as defined in Article 1 of the UAE Commercial Companies Law<sup>2</sup>) in which the UAE Federal Government, the Government of any Emirate, or any governmental authority or body of any of them has any direct or indirect ownership in its share capital. By contrast, Article 3.2 of the Guidance states that the Regulations do not apply to any commercial company with at least 51% direct or indirect governmental ownership. An EU document indicates that the change to the 51% threshold was made to accommodate concerns of the EU Code of Conduct Group that exempting companies with any government ownership created a risk of circumvention of the substance requirements.

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<sup>2</sup> UAE Federal Law No. 2 of 2015, as amended.

#### **4. Filing requirements commence with effect from 1 January 2020**

Under Article 8(1) of the Regulations, a Licensee shall notify the Regulatory Authority annually of the following:

*“(a) Whether or not it is carrying on a Relevant Activity.*

*“(b) If the Licensee is carrying on a Relevant Activity, whether or not all or any part of the Licensee’s gross income in relation to the Relevant Activity is subject to tax in a jurisdiction outside of the State; in all cases such Licensee shall provide the Regulatory Authority with all information and documentation required to be submitted by it pursuant to this Resolution or any further guidance or decision issued pursuant to this Resolution.*

*“(c) The date of the end of its Financial Year.”*

Under Article 8(2) of the Regulations, the foregoing annual filing shall be made at the time specified by the Regulatory Authority and in the manner approved by the Regulatory Authority. As noted above, the Regulatory Authority has not yet been identified. However, Article 4.2 of the Guidance clarifies that such filing must be made with effect from 1 January 2020. This suggests the Competent Authority believes (or assumes) that the Regulatory Authority will be appointed before 1 January 2020.

#### **5. List of core activities in the Regulations is not exhaustive**

The Regulations require a Licensee to demonstrate that it conducts its State Core Income-Generating Activities in the UAE. Article 5 of the Regulations identifies, for each Relevant Activity, certain activities that must be carried out in the UAE.

Article 4.3(a) of the Guidance explains that the list set out in Article 5 of the Regulations “*is not exhaustive*” and that the list “*includes the activities listed but is not limited to them.*” The Guidance further explains that the general principle is that the activities listed in Article 5 of the Regulations “*are regarded to be the most important activities that a Licensee carrying out a Relevant Activity is expected to be carrying on in the UAE.*”

#### **6. Directed and managed in the UAE**

One of the requirements of meeting the Economic Substance Test, under Article 6(2)(b) of the Regulations, is that a Licensee must be directed and managed in the UAE in relation to its Relevant Activity. Article 4.3(b) of the Guidance explains that the aim is to ensure that there are an adequate number of board meetings held and attended in the UAE. Article 4.3(b) of the Guidance further explains that:

*“A determination as to whether an adequate number of meetings are held and attended in the UAE will be dependent on the level of Relevant Activity being carried out by a Licensee. It is expected that it must be at least one (1) meeting held in a Financial Year in the UAE. Consideration must also be given to meeting requirements prescribed under the applicable law regulating the Licensee or as may be stipulated in the constitutional documents of the Licensee.”*

Additional requirements highlighted in Article 4.3(b) of the Guidance include:

- meetings shall be recorded in written minutes and signed by attendees and such minutes are kept in the UAE;
- quorum for such meetings shall be met and those attendees are physically present in the UAE;
- directors shall have the necessary knowledge and expertise to discharge their duties; and
- the minutes of board meetings must refer to all the relevant decisions taken and must be signed by directors physically present.

## 7. Meaning of “adequate” and “appropriate”

The Regulations use the undefined term “adequate” in several places. For example, “adequate number of qualified full-time employees”, “adequate level of expenditure”. In addition, the Guidance uses the terms “adequate” and “appropriate” several times. Article 4.3(g) of the Guidance explains that businesses vary in size and therefore the employees, expenditures and premises which are adequate or appropriate for a large or medium sized business may not be adequate or appropriate for a small business and that the Regulations are not intended to impose requirements to engage employees or incur expenditures beyond what is actually required by a business.

What is adequate or appropriate for each Licensee will be dependent on the nature and level of Relevant Activity being carried out by such Licensee. But a Licensee should maintain sufficient records to demonstrate the adequacy and appropriateness of the resources utilized and the expenditures incurred.

Article 4.3(g) also explains that the requirement for adequate employees is aimed at ensuring that employees carrying out a Relevant Activity are suitably qualified to do so.

## 8. Outsourcing

The Regulations permit the use of the third party service providers to satisfy certain requirements of the Economic Substance Test. Article 4.3(h) of the Guidance explains certain criteria that the third party service providers must meet including, by way of example, having adequate activities, employees, expenditures and premises in the UAE. Article 4.3(h) of the Guidance contains further elaboration and explanation of requirements for outsourcing that is not discussed herein but may be of interest to businesses subject to the Regulations who use third party service providers.

Article 4.3(h)5 of the Guidance explains that a Licensee 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. This is perhaps one topic on which the Guidance may have created more potential confusion than clarification. It is not clear under what circumstances outsourcing would be deemed to be circumventing compliance.

## 9. Holding company business

Under Article 6(4) of the Regulations, a Holding Company Business that derives its income solely from dividends and capital gains is subject to reduced substance requirements. Such Licensee must satisfy only two criteria:

- compliance with requirements to submit any documents, records or information to the relevant Regulatory Authority; and
- maintaining adequate employees and holding and managing for the Holding Company Business.

Article 5.1 of the Guidance explains that Holding Company Businesses that undertake a Relevant Activity and derive income from such activity other than solely receiving income from equity interests do not benefit from this exemption and must meet the full substance requirements of the Economic Substance Test. The Guidance further explains that:

*“A Licensee which owns other forms of assets (e.g. bonds, government securities, interest in real property) will clearly not be a ‘pure equity holding’ entity (even if it also owns equity participations) and will not be treated as carrying on holding business.”<sup>3</sup>*

<sup>3</sup> The phrase “will not be treated as carrying on holding business” is potentially confusing. Read in the context of the entirety of Article 5.1 of the Guidance, we interpret this to mean that a Licensee owning other forms of assets such as bonds, securities, etc., would not be able to qualify for the reduced substance requirement under Article 6(4) of the Regulations. We do not interpret this phrase to mean ownership of other assets would automatically result in a company not being a holding company.

Moreover:

*“Because it is possible for a Licensee to carry on more than one Relevant Activity, the fact that the Licensee is a ‘pure equity holding entity’ does not preclude the possibility that it may carry on one or more other relevant activities, in which case the CIGA [Core Income Generating Activities] shall be those associated with the income generated.”*

### **10. Headquarters business**

Article 5.2 of the Guidance explains that whether an entity carries on a headquarters business for the purposes of the Regulations is entirely dependent on the services it provides to other group companies and is not dependent on its position in the group structure.

### **11. High risk intellectual property activity**

The Regulations identify certain activities relating to Intellectual Property Business as high risk and set out additional conditions that a Licensee carrying out such activities must satisfy. Article 5(3) of the Guidance explains that because income derived from intellectual property assets activity poses a greater risk of artificial profit shifting as compared to income from non-IP related activity, there is a presumption under the Regulations that a Licensee who carries out such activities is not complying with the Economic Substance Test. The burden is placed on the Licensee to rebut this presumption by providing sufficient evidence *“demonstrating that the Licensee does and historically has exercised a high degree of control over the development, exploitation, maintenance, enhancement and protection of the Intellectual Property Asset by an adequate number of full-time employees, with the necessary qualifications, who permanently reside and perform their activities in the UAE.”*

### **12. Businesses should retain records for at least six years**

Under Article 7(1) of the Regulations, the Regulatory Authority may make a determination that a Licensee has not met the Economic Substance Test no later than six (6) years from the end of the Financial Year to which the determination relates. Article 4.4 of the Guidance explains that while the Regulations do not prescribe a set period for the retention of information by a Licensee, it is advisable to retain information relevant to evidencing compliance for a period of at least six (6) years.

### **13. Disclosure to overseas regulators**

Article 9 of the Regulations addresses the exchange of information with foreign regulators. Article 9(3) states:

*“Upon receipt by the Competent Authority of notification containing information that a Licensee has not met the Economic Substance Test for a Financial Year from a Regulatory Authority pursuant to the above Clause 2, the Competent Authority shall, pursuant to an international agreement, treaty or similar international arrangement to which the State is a party, provide the information relating to such Licensee to –*

*(a) the Foreign Competent Authority of the country or territory in which resides the parent company, the ultimate parent company, and the Ultimate Beneficial Owner of the Licensee.*

*(b) If the Licensee is incorporated outside the State, the Foreign Competent Authority of the country or territory in which the Licensee is incorporated.”*

Article 6.4 of the Guidance explains that the Competent Authority shall provide information to the Foreign Competent Authority:

- if a Licensee fails to meet the requirements under the Regulations for a specific Financial Year; or
- the Licensee carries out a High Risk IP business.

## UAE removed from European Union Tax Blacklist

The UAE Economic Substance Regulations were enacted after the UAE had been put on EU's blacklist of non-cooperative jurisdictions for tax purposes. On 10 October 2019, the EU issued a press release announcing that the UAE has been removed the blacklist. This topic is covered in more detail in Afridi & Angell's [Legal Alert dated 10 October 2019](#).

### Next steps

All businesses in the UAE should make an assessment as to whether they are subject to UAE Economic Substance Regulations and those that are subject to the Regulations should begin initiating steps to ensure compliance with the Regulations. While the Regulatory Authority has not yet been appointed, the Guidance states that reporting requirements will commence on 1 January 2020 so it is anticipated that the Regulatory Authority will be appointed before year end. It would be prudent to start taking steps to comply with the Regulations as soon as possible. ■

### Afridi & Angell

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