

To ensure that certain sensitive sectors demonstrate economic substance contributing to the country's economy is important ... for development and growth, both for the country and the business. This note sets out a synopsis of the recent regulations in the UAE implementing the doctrine of economic substance

# UAE's Doctrine of Economic Substance

... a synopsis of the recent regulations

Aditya Shroff and Nicole Shroff

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# UAE's DOCTRINE OF ECONOMIC SUBSTANCE

Co-authored By:

Aditya Shroff – [aditya.shroff@anshlegal.com](mailto:aditya.shroff@anshlegal.com)

Nicole Shroff – [nicole.shroff@anshlegal.com](mailto:nicole.shroff@anshlegal.com)

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*Both authors are partners at ANSH Legal Private Limited, a legal consultancy authorized in Abu Dhabi Global Market. The views expressed in this note are generic and those of the authors based on their past experience in international transactions and structures and does not constitute the view or opinion of any other person. This note does not constitute legal advice and readers should take appropriate legal advice for any matters referred to in this note.*

## 1. Introduction

In response to the global standards set by the Organisation of Economic Cooperation and Development (“**OECD**”) in relation to harmful tax practices, which require companies to have substantial activities in a jurisdiction, the European Union of Conduct Group (“**COCG**”) adopted a resolution on a code of conduct for business taxation, the aim of which is to curb harmful tax practices. This note discusses the applicability and effect of the implementation of the doctrine of economic substance (the “**Doctrine**”) in the UAE. The Doctrine requires a transaction to have both:

- (i) a substantial purpose aside from reduction of tax liability; and
- (ii) an economic effect aside from the tax effect in order to be considered valid.

In effect, the transaction must change the taxpayer's economic position in a "meaningful way" apart from the federal income tax effects, and the taxpayer must have had a "substantial purpose" for entering into the transaction, apart from the federal income tax effects.

## 2. The Doctrine in the UAE

2.1 The Cabinet of Ministers Resolution no. 31/2019 effective 30 April 2019 concerning Economic Substance Regulations in the UAE (the “**Resolution**”) read with the UAE Ministry of Finance’s Ministerial Decision No. 215 of 2019 dated 11 September 2019 setting out the directive for implementation of the provisions of the Resolution (the “**Decision**”), sets out the requirements for a natural or juridical person licensed to carry out any activity specified under the Resolution in the UAE to derive an income from such activity, to meet the test of economic substance (the “**ESR Test**”). The key features of the ESR Test are:

- (a) such person conducts ‘State Core Income Generating Activity’ in the UAE, as defined in the Resolution. These activities include banking, insurance, investment fund management, lease finance, acting as the headquarters of a group, acts as a holding company, shipping, intellectual property business and distribution and service centre business. Definitions for each of these activities are set out in the Resolution;

- (b) such person is directed and managed in the UAE in relation to the activity – this requires the board of directors of that person to meet at least once in a financial year in the UAE, have written minutes of such meeting signed by the attending directors, record the strategic decisions taken and maintain the same in the UAE subject to the applicable license requirements or under applicable law or its constitutional documents and directors should be fit for purpose. If the UAE activities of a company are being managed by a sole manager, such manager should be present at the time of the company making key decisions relating to the branch or representative office in the UAE;
- (c) the person has an adequate number of qualified full-time employees, whether on temporary or long-term contracts in the UAE or outsourced in the UAE and is incurring adequate expenditure on such employees for carrying out the relevant activity;
- (d) the person is incurring adequate expenditures on outsourcing to third party service providers whose activities, employees and premises are in the UAE and are adequate for carrying out the relevant activity;
- (e) it has adequate physical assets in the UAE whether in-house or outsourced to third parties for its activities;
- (f) it has the ability to monitor and control the carrying out of a relevant activity outsourced to a third-party service provider; and
- (g) the person has the ability to demonstrate adequate supervision of the outsourced activity.

2.2 All existing entities are required to comply with the requirements of the ESR Test from 30 April 2019 and new licensees are required to comply with the requirements upon receiving the trade license, with the first report due in 2020 in both cases. Entities in which the UAE Federal Government, the Government of any Emirate of the UAE or any UAE governmental authority has at least 51% direct or indirect ownership interest are exempt from complying with the ESR Test.

2.3 The degree of substance requirements for an entity depends on the type of relevant activity of that entity. For example, holding companies that do not carry on any other relevant activity and solely hold equity participation in other entities have a reduced substance requirement, such as submission of documents, records or information to the relevant authority when required by it and maintaining adequate employees and premises for holding and managing the holding company's business. Other holding companies that undertake a relevant activity and derive income from such activity are required to comply

with the full substance requirements of the ESR Test. Entities that derive an income from intellectual property assets that are considered to be high risk must comply with higher reporting requirements and standards to meet the requirements of the Resolution. A brief description of the relevant activities is set out in the Appendix.

2.4 There are reporting requirements applicable to all licensed entities carrying out a relevant activity, summarized below.

#### 2.5 **Reporting Requirements**

A licensee is required to report certain information annually to its regulator (being the authority that issued its trade license) with effect from 1 January 2020. These include:

- (a) whether or not it is carrying on a relevant activity;
- (b) whether the income generated by the relevant activity is subject to tax in a jurisdiction outside the UAE;
- (c) the date of the end of its financial year;
- (d) submit a report on certain matters to the regulator within 12 months of the end of its financial year such as the type of relevant activity, the amount of income and operating expenses relating to the activity, location of business, plant and machinery, number of personnel, declaration on satisfaction of ESR Test, information relating to high risk intellectual property business and outsourced activities as prescribed.

#### 2.6 **Record Keeping**

- (a) While no specific period has been prescribed for retention of records relating to the ESR Test by a licensee who is subject to the Resolution, a regulatory authority has a six year period to determine whether a licensee has met with the requirements of the Test in relation to its relevant activity. Hence, it will be advisable to maintain records of any relevant information evidencing compliance with the Resolution for a period of 6 years after the end of each financial year.
- (b) All records must be maintained in English.

#### 2.7 **Penalties for non - compliance**

- (a) An administrative penalty of AED10,000 to AED50,000 for failure to meet the ESR Test is imposed in the first financial year. This amount may be increased to an amount not less than AED50,000 but not exceeding AED300,000 in the subsequent years, subject to a six-year limitation period.

The six-year limitation implies that the relevant regulatory authority need not give its decision as to compliance with the ESR Test by a licensee immediately at the end of the relevant financial year and has six years after the end of the relevant financial year to decide such compliance. If such regulatory authority does not give its decision within this period, the licensee will not be subject to any consequence for non - compliance with the ESR Test for that relevant finance year unless the relevant authority has not been able to make such decision by reason of gross negligence, fraud or deliberate misrepresentation by the licensee or any other person.

- (b) The trade license of the relevant entity may be suspended, revoked and renewal may be refused if the entity fails to meet the ESR Test.

## **CONCLUSION**

The introduction of the Regulations in the UAE brings the UAE in line with other jurisdictions that have recently issued economic substance legislations and affirms the UAE's commitment to addressing concerns around the shifting of profits derived from certain mobile business activities to "no or nominal tax jurisdictions" without corresponding local economic activities. This move will go a long way in meeting the OECD requirements and recognising UAE as a co-operating country globally while reasserting its position in the global list of 'Ease of Doing Business'.

## APPENDIX

The following is an indicative list of some of the core income generating activities.

<b>Banking</b>	Raising funds, managing risks, taking hedge positions, providing loans, credit or other financial services to customers, managing capital and preparing reports to investors or any government authority.
<b>Insurance</b>	Predicting and calculating risk, insuring or re-insuring against risk and providing insurance business services to clients, underwriting insurance and reinsurance.
<b>Investment Fund Management</b>	Taking decisions on the holding and selling of investments on behalf of clients, calculating risk and reserves, taking decisions on currency or interest fluctuations and hedging positions and preparing reports to investors or any government authority.
<b>Lease Finance</b>	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.
<b>Headquarters</b>	Taking relevant management decisions, incurring operating expenditures on behalf of group entities, coordinating group activities.
<b>Holding Company</b>	All activities related to the business that derives income from dividends and capital gains from the equity interest.
<b>Shipping</b>	Transporting persons, animals, good or mail by sea, chartering of ships for the same purpose, managing crew (including hiring, paying and overseeing), overhauling and maintain ships, overseeing and tracking ships, maintenance or rental of shipping containers and other equipment used for transport by sea. Determining what goods to order and when to deliver them, organizing and overseeing voyages.
<b>IP Business</b>	Where the IP asset is (i) a patent or an asset similar to a patent, research and development (ii) non-trade intangible, branding, marketing and distribution. If such activity is considered high risk then the state core income generating activity must include any of the following activities (a) taking strategic decisions and managing the risks related to the development and subsequent exploitation and protection of the intangible assets (b) taking strategic decisions and managing the risks related to the acquisition by third parties and subsequent exploitation and protection of the intangible asset. (c) carrying on the ancillary trading activity through which the intangible assets are exploited leading to the generation of income from third parties.
<b>Distribution and Service Centre</b>	importing and storing component parts from a natural or juridical person not a resident in the UAE, materials or goods ready for sale, reselling such component parts, managing inventories, taking orders, providing services to a person not resident in the UAE.