

UAE enacts economic substance rules

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Executive summary

The United Arab Emirates (UAE) enacted *Cabinet Decision No.31 concerning setting the economic substance requirements* on 30 April 2019. Companies engaged in banking, insurance, fund management, investment holding, financing and leasing, distribution and service center, headquarter companies and intellectual property (IP) activities should review the effect of the new rules to ensure they meet the substance requirements. Failing to do so may result in penalties and fines, spontaneous exchange of information, and potentially deregistration. The rules entered into force on 30 April 2019.

Detailed discussion

Background

The enactment of the new economic substance requirements is a result of the recent work conducted by the Organisation for Economic Co-operation and Development (OECD) under Action 5 of the Base Erosion and Profit Shifting (BEPS) project, as well as an investigation by the European Union (EU) Code of Conduct Group (COCG) into certain low or no corporate income tax regimes. In recent years the EU has focused more directly on the tax policies of jurisdictions with zero or nominal tax, and whether those jurisdictions require investors to have

sufficient economic substance before benefitting from preferential tax regimes on geographically mobile resources. One outcome of this work has been the publication of the EU list of non-cooperative tax jurisdictions, which currently includes the UAE.

In response to EU COCG initiatives, the governments of Bahamas, Bermuda, British Virgin Islands (BVI), Cayman Islands, Guernsey, Isle of Man, Jersey, Mauritius and Seychelles introduced economic substance rules with effect from 1 January 2019. The rules are based on the guidance and requirements issued by the EU and the OECD, and are designed to ensure that companies operating in a low or no corporate tax jurisdiction have a substantial purpose other than tax reduction and an economic outcome that is aligned with value creation.¹ To align with the international standards, the UAE has now enacted substance rules.

UAE economic substance rules

The UAE enacted economic substance rules on 30 April based on the EU recommendations outlined in the scoping paper issued by the EU COCG on 22 June 2018 and OECD guidance on harmful tax practices in Action 5 of the BEPS action plan.

The rules apply to companies engaged in core income generating activities (CIGA) such as banking, insurance, fund management, financing and leasing, headquarter companies, shipping business, investment holding, IP activities and distribution and service center. The scope of the new provisions includes all companies carrying out relevant activities except for any commercial company owned directly or indirectly by the UAE Government or any subordinate government authority.

To meet the economic substance requirement, companies will generally need to satisfy the following three tests:

1. The company should be directed and managed in the UAE for the specific activity.
2. The company's CIGA should be performed in the UAE.
3. The company should have an adequate level of qualified employees, premises and annual operating expenditures.

Entities may outsource CIGA activities (with the exception of "high risk" IP), provided the outsourced activities are carried out inside the UAE and the entity retains full control over those activities. In line with the EU recommendations, pure holding companies shall be subject to less stringent substance requirements. Furthermore, additional reporting requirements apply to "high-risk" IP companies.

Entities carrying on relevant activities that fall within the scope of the regulations would need to prepare a report to the regulatory authority, demonstrating that they satisfy the economic substance test, no later than 12 months after the end of each financial year. The regulatory authority will then submit the report to the competent authority, the UAE Ministry of Finance.

It is expected that further executive regulations will be issued to provide more clarifications with respect to the provisions of the new economic substance regulations, including the implementation details.

Implications

Corporate businesses, wealth management groups and family offices with any relevant activities should assess whether the economic substance laws impact their current and envisaged UAE operations. Non-compliance could result in administrative penalties for failure to meet the economic substance test (up to AED50,000 in the first financial period, and up to AED300,000 in subsequent financial periods), administrative penalties for failure to provide information (up to AED50,000), spontaneous exchange of information, and potentially deregistration.

From a wider perspective, UAE businesses should review economic substance in relation to such considerations as:

- ▶ Access to treaty benefits in view of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, signed by the UAE on 27 June 2018
- ▶ International transfer pricing rules and documentation requirements
- ▶ Application of foreign anti-avoidance rules, such as controlled foreign company rules

Endnote

1. For details, see our earlier alert on [New substance requirements for zero and no tax jurisdictions](#).

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