

Bahrain clarifies economic substance requirements

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Executive summary

Bahrain has enacted legislation concerning economic substance requirements for certain regulated financial activities effective from 1 January 2019, as well as certain non-regulated activities from 1 July 2019. Companies engaged in banking, insurance, fund management, investment holding, financing and leasing, distribution and service center, headquarter companies and intellectual property (IP) activities in Bahrain should ensure they meet the substance requirements. Failing to do so may result in penalties, fines, spontaneous exchange of information and potentially deregistration.

Detailed discussion

Background

Since the Organisation for Economic Co-operation and Development (OECD) and G20 countries adopted a 15-point Base Erosion and Profit Shifting (BEPS) Action Plan in 2013, BEPS has remained a key priority for governments around the globe. The Final Reports, issued in 2015, represent a package of measures that governments should implement to address features of tax regimes that facilitate BEPS. The package includes a set of minimum standards that must be met by countries signing up to the BEPS Inclusive Framework. One of those

standards is Action 5 concerning harmful tax practices, which requires members of the Inclusive Framework to review preferential regimes that risk being used for artificial profit shifting; essentially regimes that allow multinationals to achieve tax benefits without having substantial activities in a jurisdiction.

In parallel with the BEPS project, the European Union (EU) Code of Conduct Group (COCG) has been reviewing 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. In 2017, that work resulted in several countries, including Bahrain, being included on the EU list of non-cooperative jurisdictions for tax purposes (EU blacklist) because they failed to meet the EU's criteria of tax transparency, fair taxation, and implementation of the minimum anti-BEPS measures.¹

Bahrain joined the Inclusive Framework on 11 May 2018, committing to implementing the BEPS minimum standards, aligning with the emerging global consensus of shared international tax rules and as a means of strengthening the business climate. Bahrain was subsequently removed from the EU Blacklist.²

The OECD's work on Action 5 has continued since 2015, with further work done on what constitutes "substantial activities," particularly for jurisdictions with zero or nominal taxation. On 22 June 2018, the EU COCG issued a scoping paper setting out economic substance requirements that zero or low-tax jurisdictions should adopt for the EU to consider that jurisdiction to be in compliance with the EU fair taxation principle. On 15 November 2018, the OECD published similar criteria in its 2018 Action 5 Progress Report.

On 22 November 2018, the Central Bank of Bahrain (CBB) issued a directive Concerning Economic Substance Requirements for certain Financial Institutions, establishing economic substance requirements for regulated financial activities, including banks, financing companies, insurance licensees, investment business firms and fund administrators. The Directive applies from 1 January 2019.

On 27 December 2018, the Ministry of Industry, Commerce and Tourism (MOICT) issued Ministerial Order No. 106 of 2018 Concerning Economic Substance Requirements in Bahrain, establishing economic substance requirements for

non-regulated commercial activities such as distribution and service centers, headquarter activities, holding company activities, shipping and IP-related activities.

Bahrain economic substance rules

The scope of the economic substance rules includes all regulated and non-regulated companies carrying out relevant activities.

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

1. The company's core income-generating activities (CIGA) should be carried out in Bahrain.
2. The company's related activities such as meetings of the board of directors, partners, managers, should be physically held in Bahrain and key strategic decisions should be set out during such meetings.
3. The company should have an adequate number of qualified full-time employees resident in Bahrain.
4. The company should have an adequate level of annual operating expenditures incurred in Bahrain.
5. Where core income-generating activities (CIGA) are outsourced to a third party, expenditures paid to such service providers should be proportionate to that service.
6. Adequate level of internal policies and controls, such as corporate governance and risk management, should be regularly reviewed including books of accounts being maintained using acceptable accounting standards.

Additional requirements apply to "high-risk" IP companies. There is a rebuttable presumption that a high-risk IP company does not satisfy the economic substance test. Businesses may rebut this presumption by showing that, historically, there has been a high degree of control over the development, exploitation, maintenance, enhancement and protection of the IP by highly skilled employees that permanently reside and perform their core activities in Bahrain. In this case, businesses will be subject to a higher evidentiary threshold and will need to provide detailed business plans and other information.

Businesses falling within the scope of the economic substance rules will need to ensure that the accounting records contain all relevant information, including the type of activities, amount and type of gross income, expenses and assets. Furthermore, upon the commercial registration or its renewal, businesses will need to provide a report to the MOICT including supporting documents and records confirming compliance with the economic substance rules.

The current economic substance rules are silent as to the actual form of reporting and other implementation details. It is expected that additional regulations or explanatory notes will be issued to provide further clarifications in this respect.

The economic substance rules came in to effect on 1 January 2019 for regulated financial activities and 1 July 2019 for non-regulated commercial activities. Affected businesses should adhere accordingly.

Consequences of non-compliance

The consequence for non-compliance includes fines of up to BHD100,000, spontaneous exchange of information, possibility of termination of commercial registration and prosecution if an investigation proves that the breach constitutes a criminal offense.

Next steps

Entities carrying out activities within the scope of the economic substance rules should assess whether the economic substance laws impact their current and envisaged operations and ensure that they meet the economic substance requirements starting 1 January 2019 for regulated financial activities and 1 July 2019 for non-regulated commercial activities.

From a wider perspective, businesses should review economic substance in relation to such considerations as: (i) access to treaty benefits; (ii) international transfer pricing rules and documentation requirements; (iii) application of foreign anti-avoidance rules, such as controlled foreign company rules.

Endnotes

1. For information on the UAE, see our alert [UAE enacts economic substance rules](#).
2. For further information, please see [Council of the European Union's final legislation and assessment of Bahrain under criterion 2.2](#).

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