

# New Resolution on Economic Substance Requirements in the United Arab Emirates

LEGAL BRIEFING (8 July 2019)

*On 30 April 2019, the Cabinet of the United Arab Emirate (UAE) issued a Resolution regarding the economic substance requirements for mainland and free zone entities in the UAE (Resolution No. 31 of 2019). The Resolution can be seen as a response to the UAE having been (re)added to the EU's tax haven blacklist in March 2019 after missing a 31 December 2018 deadline for passing economic substance requirements. UAE companies will need to assess whether they are eligible to meet the criteria of the Resolution. This legal briefing provides an overview of the implications of the new economic substance legislation in the UAE.*

## **1. What are the new Economic Substance Requirements and whom do they affect?**

### **a. What is the history behind the Economic Substance Requirements?**

Economic substance requirements are a set of rules demanding corporate bodies operating in jurisdictions with low or no corporate taxes to prove a certain degree of substance allowing them to carry out their respective commercial activity, rather than simply having a presence for the purpose of tax avoidance.

The Council of the European Union (EU) has adopted a resolution on a Code of Conduct for business taxation in order to combat the effects of zero tax and/or preferential tax regimes around the world. In 2017, the Code of Conduct Group investigated tax policies of both, EU member states and third countries, against the following criteria:

- tax transparency;
- fair taxation; and
- implementation of anti-BEPS measures (short for "Base Erosion and Profit Shifting" – an international project of the

Organisation for Economic Cooperation and Development – OECD).

The UAE was originally included on the EU's list of non-cooperative tax jurisdictions (EU Tax Haven Blacklist) in 2017. The Code of Conduct Group concluded that the UAE has to implement economic substance requirements. The UAE was removed from the list after committing itself to adopting the tax standards as required by the EU. The Cabinet of Ministers Resolution No. 31 of 2019 (Resolution) is a consequence of the country's reinclusion to the list on 12 March 2019.

### **b. Which corporate vehicles are potentially affected?**

The economic substance requirements apply to various kinds of corporate vehicles in the UAE (e.g. limited liability companies, branches, representative offices, etc.) that carry out one of the following activities (also referred to as "Relevant Activity", Art. 4(a) Resolution):

- (i) banking business;
- (ii) insurance business;
- (iii) fund management business;
- (iv) finance and leasing business;
- (v) intellectual property business;

- (vi) holding company business;
- (vii) distribution and service centres;  
and
- (viii) shipping.

Federal and local UAE governmental entities are excluded from the Resolution.

## **2. What are the criteria to pass the Economic Substance Test?**

According to Art. 6 Resolution, entities operating in one of the aforementioned Relevant Activities must pass an economic substance test. The test has the following requirements:

- (i) Retrieve income from so-called Core Income Generating Activities (CIGA) in the UAE;
- (ii) Be directed and managed in the UAE;
- (iii) Have an adequate number of qualified full-time employees in the UAE;
- (iv) Have an adequate operating expenditure incurred in the UAE; and
- (v) Have adequate physical assets in the UAE.

Point (ii) implies that if a company maintains a board of directors, the board must have an adequate frequency of meetings in the UAE. Meetings should be recorded by minutes and signed by the board members.

In general, it is possible to outsource CIGA activities to third parties, however, these activities must be carried out in the UAE. Furthermore, the corporate vehicle must oversee the execution of outsourced activities.

It should be noted that the economic substance test is relaxed when carrying out holding activities. In this case, only adequate employees and premises for holding and managing the company are required.

## **3. What are the reporting requirements?**

Corporate vehicles that carry out Relevant Activities are required to submit an annual report no later than 12 months after the end of each financial year to the so-called Regulatory Authority. At the moment, it is unclear who the Regulatory Authority will be since respective legislation needs to be enacted. Regardless of this, it is expected that the licensing authority (e.g. the relevant Department of Economic Development or Free Zone Authority) will be competent. Since the Resolution came into force in April 2019, the first report will be due in 2020.

Among other things, the report must include certain information, as listed in Art. 8(4) Resolution:

- Whether or not a Relevant Activity is carried out;
- The type of Relevant Activity and amount of income related thereto;
- The location of the activity (and if applicable, property or equipment used to conduct the Relevant Activity);
- The number of employees and their qualifications; and
- A declaration by the respective corporate vehicle stating that it passed the economic substance test.

It is expected that detailed regulations regarding the reporting requirements will be passed in due course.

## **4. What are the Penalties in case of Non-Compliance?**

The fines for not complying with the criteria of the economic substance test (Art. 10 Resolution) or the reporting requirements (Art. 11 Resolution) are generally the same.

Penalties for not meeting the criteria/requirements range from AED 10,000 to

50,000 (approx. EUR 2,500-12,500). However, in case the corporate vehicle fails to pass the economic substance test according to the Regulatory Authority's in a consecutive financial year, the fine will increase substantially (to AED 50,000-300,000 (approx. EUR 12,500-75,000)). In case the respective corporate vehicle continues to fail meeting the criteria, alternative sanctions such as suspension, revocation or non-renewal of the license may be imposed.

Apart from determining the penalty amount, the Regulatory Authority will also mention the reasons for imposing the respective penalty. The Regulatory Authority's decision is appealable. The regulations

regarding the appeal procedure still need to be passed.

Penalties cannot be imposed six years after the date on which the corporate vehicle became liable to the penalty.

## **5. Conclusion**

The enactment of economic substance requirements is a reaction to the UAE's ambition to be removed from the EU Tax Haven Blacklist. Regardless of this, companies seeking to invest in and/or through the UAE, as well as businesses operating in the UAE, should review their activities and if the necessary level of economic substance in order to comply with the requirements.

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