

Economic Substance Regulations (ESR)

On 10th August 2020, the Cabinet Ministers of the United Arab Emirates (UAE) issued Cabinet Resolution No. 57 of 2020 which repealed and replaced the earlier ESR Regulations. ESR Regulations are issued pursuant to the global standard set by the Organisation for Economic Co-operation and Development (“OECD”) Forum on Harmful Tax Practices, which requires entities undertaking geographically mobile business activities to have substantial activities in a jurisdiction.

Every entity is required to assess the applicability of the regulations set out in the Cabinet Decision and comply with the same if applicable. This can be undertaken in four stages as follows:

Stage 1: Assessing the applicability of ESR Regulations on the entity

ESR Regulations only apply to “Licensees” and “Exempted Licensees”.

A “Licensee” has been defined as a juridical person (incorporated inside or outside UAE) or an unincorporated partnership, registered in UAE and carrying on a “Relevant Activity”.

“Relevant Activity” have been defined as any of the following activities:

- Banking Business;
- Insurance Business;
- Investment Fund Management Business;
- Lease-Finance Business;
- Headquarters Business;
- Shipping Business;
- Holding Company Business;
- Intellectual Property Business; and
- Distribution and Service Centre Business.

The Cabinet Decision further defines each of these Businesses and hence, going by the general meaning of the Business is not correct. For example, in the case of Distribution and Service Centre Business, only those businesses that purchase goods from “Foreign Connected Person” for resale or providing services to “Foreign Connected Person” are covered in its definition while such restriction to “Foreign Connected Person” does not apply in the case of, say, Lease-Finance Business.

Stage 2: Assessing whether the entity is an “Exempted Licensee”

Once an entity identified itself as a Licensee, it should check whether it is an exempted licensee. An Exempted Licensee has reduced compliance burden as it is not required to satisfy the Economic Substance Test and furnish Economic Substance Report.

The following are covered under “Exempted Licensees”:

- A licensee that is an Investment Fund;
- A licensee that is a tax resident in a jurisdiction other than UAE;
- A licensee that is wholly owned by one or more residents in UAE and:
 - Is not a part of an MNE Group; and
 - Only carries out business in UAE.
- A licensee that is a branch of a foreign entity whose “Relevant Income” (gross income from Relevant Activity) is subject to tax in a jurisdiction other than UAE.

Stage 3: Preparation and Submission of Notification

Both **Licensees** and **Exempted Licensees** are required to notify, within 6 months of the end of its Financial Year, the following to the Regulatory Authority:

- The relevant activity being carried out;
- Whether it has generated relevant income;
- The date of commencement and end of its financial year; and
- Any other information and documents requested by the Regulatory Authority.

In addition to the above, an Exempted Licensee shall also submit information and documentation evidencing its status as an Exempt Licensee. Where an exempted licensee fails to comply with the reporting requirements, all provisions of the regulation shall apply to such exempted licensee as applicable to a licensee, i.e., it shall not hold the status of an exempted licensee for that financial year.

Stage 4: Preparation and Submission of Economic Substance Report

All Licensees, other than an exempted licensee, must satisfy the Economic Substance Test in the Financial Year in which it has Relevant Income and submit an Economic Substance Report to the Regulatory Authority within 12 months from the end of the Financial Year.

The Economic Substance Test lays down certain conditions depending on the type of Relevant Activity conducted by the licensee. These conditions include that Core Income-Generating Activities are conducted in UAE, Relevant Activity is directed and managed in UAE and adequate qualified employees, operating expenses and assets are incurred/located in UAE with regard to the level of Relevant Activity being performed. These conditions in essence prove that there is an economic substance for the entity being located in UAE and that it is not merely set up for tax evasion purposes.

Failure to comply with the ESR Regulations shall attract penalties of AED 20,000 or AED 50,000.

Therefore, it is critical that every entity assess the applicability of the ESR Regulations on their entity and where it is applicable, ensure compliance with the Regulations.

Our Services

We, at Sai Management Consultancies, are happy to offer you the services of:

- assessing the applicability of ESR Regulations on your entity;
- preparation and timely submission of the Notification to Regulatory Authority and the maintenance of required documents;
- performance of Economic Substance Test;
- preparation and timely submission of the Economic Substance Reports to the Regulatory Authority and the maintenance of required documents; and
- assistance in responding to further information requested by the Regulatory Authority.