



Economic substance regulations in the UAE

**Overview of requirements and
compliance obligations**

July 2021



Background

As a result of European Commission concerns, the United Arab Emirates (UAE) was added to the European Union's list of non-cooperative tax jurisdictions. In response, the UAE introduced Economic Substance Regulations (ESR) vide Cabinet Decision No. 57 of 2020, effective from 1 January 2019.

ESR effectively imposes a requirement for UAE entities (including offshore companies and branches of local and foreign companies) that carry out and earn income from any of the Relevant Activities to maintain economic substance in the UAE specific to each Relevant Activity. Annual filing requirements must be met or organizations risk penalties for non-compliance.

This document highlights requirements under ESR and provides information on notification and reporting compliances, including some of the practical challenges associated with ESR.



Relevant Activities

Entities that conduct one or more of the stated activities will be subject to ESR:

- Banking
- Shipping
- Insurance
- Holding company
- Investment fund management
- Intellectual property
- Lease-finance
- Distribution and service center
- Headquarters

A 'substance over form' approach must be adopted when determining whether an entity is carrying out any of the Relevant Activities. The assessment is required to be made for individual UAE entities. There is no applicable minimum income threshold.

ESR compliance obligations

Notification

UAE entities that conduct any one or more of the Relevant Activities must file a notification within six months of the end of the financial year (FY) on the Ministry of Finance's (MoF) online ESR portal. As part of this filing, entities must disclose which relevant activities were conducted, whether any income was earned therefrom and whether such income was subject to tax outside the UAE.

In the case of a UAE entity with multiple UAE branches, only one consolidated notification is to be submitted.

Economic Substance Tests

UAE entities that have earned income from any Relevant Activity(ies) must demonstrate adequate substance in the UAE relating to such activity(ies) by satisfying the following three Economic Substance Tests (ES Tests):

- Core Income Generating Activity (CIGA) test requiring the core activities to be performed in the UAE
- Directed and Managed test requiring the business to be directed and managed from the UAE in relation to the Relevant Activity(ies); and
- 'Adequacy' test requiring adequate resources (employees, expenses and assets) in the UAE

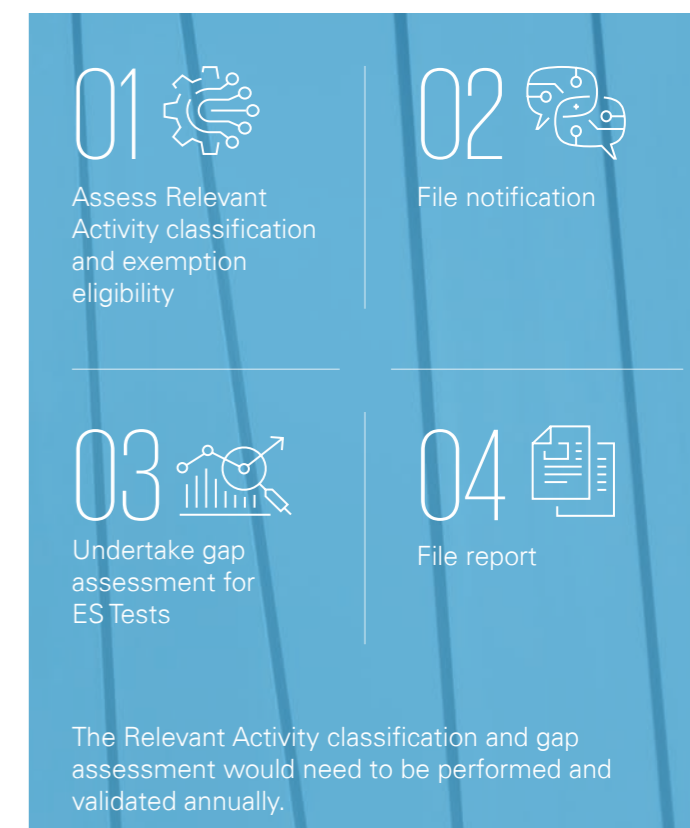
Holding companies are subject to reduced ES Tests whereas, High risk Intellectual Property businesses are subject to enhanced ES Tests.

In determining whether an entity has adequate economic substance in the UAE, authorities are expected to consider the impact of Covid-19 (e.g. travel restrictions, which do not allow directors to travel to the UAE for board meetings) based on a notification issued by the MoF. However, the facts in each case should be carefully reviewed by businesses and documented along with considerations regarding the appointment of alternative directors.

Report

Entities that have earned income from any Relevant Activity(ies) must file a report on the MoF's online ESR portal within the twelve (12) months of the end of the relevant FY. As part of this filing, entities are required to disclose various details, including:

- Whether or not they have met the ES Tests
- Details of outsourced service provider(s) (if applicable)
- Details of specific CIGAs conducted
- Operating expenditure and number of full-time employees for each Relevant Activity
- Details of parent, ultimate parent and ultimate beneficial owner



Exemptions

Certain entities conducting Relevant Activities are exempt from the requirement to maintain adequate economic substance in the UAE. Subject to meeting certain conditions, this exemption is available to:

- Investment funds
- Entities owned by UAE nationals that are not part of a multinational group and conduct business only in the UAE
- Entities that are tax residents outside of the UAE
- Branches of foreign entities

An entity making an exemption claim is only required to file a notification along with the relevant documents for substantiating the claim. Where the exemption claim is denied, such an entity will be required to meet the ES Tests and file a report.

Administration

Regulatory authorities (like free zone authorities and mainland licensing authorities) and the Federal Tax Authority (FTA) are responsible for monitoring and regulating ESR compliances.

Regulatory authorities monitor compliance with the filing requirements and verify notifications and reports filed by the licensees. They also assess exemption claims.

The FTA is empowered to assess and determine whether a licensee has met the ES Tests and levy penalties, as applicable. The time limit of six years does not apply where the FTA is unable to make the determination due to misrepresentation, fraudulent action or gross negligence by the Licensee.

For an overview of the ESR process, kindly refer to the next page.

Penalties

Failure to file notification	– AED 20,000
Failure to file report	– AED 50,000 – Deemed failure to meet ES Tests
Failure to provide accurate or complete information	– AED 50,000 – Deemed failure to meet ES Tests
Failure to meet ES Tests	<i>1st year</i> – AED 50,000 – Information exchange with foreign competent authorities <i>2nd consecutive year</i> – AED 400,000 – Information exchange with foreign competent authorities – Suspension, cancellation or non-renewal of trade license

Recent developments

The UAE has begun exchanging information with the relevant foreign authorities regarding entities that have failed the ES Test(s) or fall in a high-risk intellectual property (IP) licensee category.

Regulatory authorities have been contacting UAE entities that have not filed any notification to reconfirm whether these entities have assessed that they are not within the scope of ESR.

Practical issues

With the first year of ESR filings (for FY2019) completed, some practical issues encountered by UAE entities are highlighted below.

1. Calculation of full-time equivalent employees and operating expenditure in relation to Relevant Activities
2. Requirement to conduct board meetings at an entity (not group) level
3. Some Relevant Activities were not considered significant and did not require strategic decision-making at board meetings during the year
4. Substantiation of ‘supervision and control’ in case of outsourcing arrangements
5. Requirement to maintain adequate documentation to demonstrate that an entity has met the ES Tests—particularly concerning the determination of ‘adequacy’, which can be subjective in nature
6. Documents to be submitted in English to support exemption claims (e.g. foreign parent tax returns)
7. Non-availability of supporting documentation for the relevant FY to make an exemption claim

Given that ESR requirements are to be met annually, clients should actively consider ESR obligations. These include putting in place demonstrable documentary evidence supporting the ES Tests and documenting the basis of preparing the report, which may be subject to audit up to a period of six years from the end of the FY.

How KPMG can help

KPMG can provide the following services with its large international tax team that has been extensively involved in advising clients on ESR matters:



Assessing whether the business activities conducted fall within any of the Relevant Activities and whether any exemption can be availed



Assistance in filing the notification



Assessing whether the Economic Substance Tests are met and advising on documentation to be maintained to support any future inquiries from the authorities



Assistance in filing the report, as well as any supporting documentation



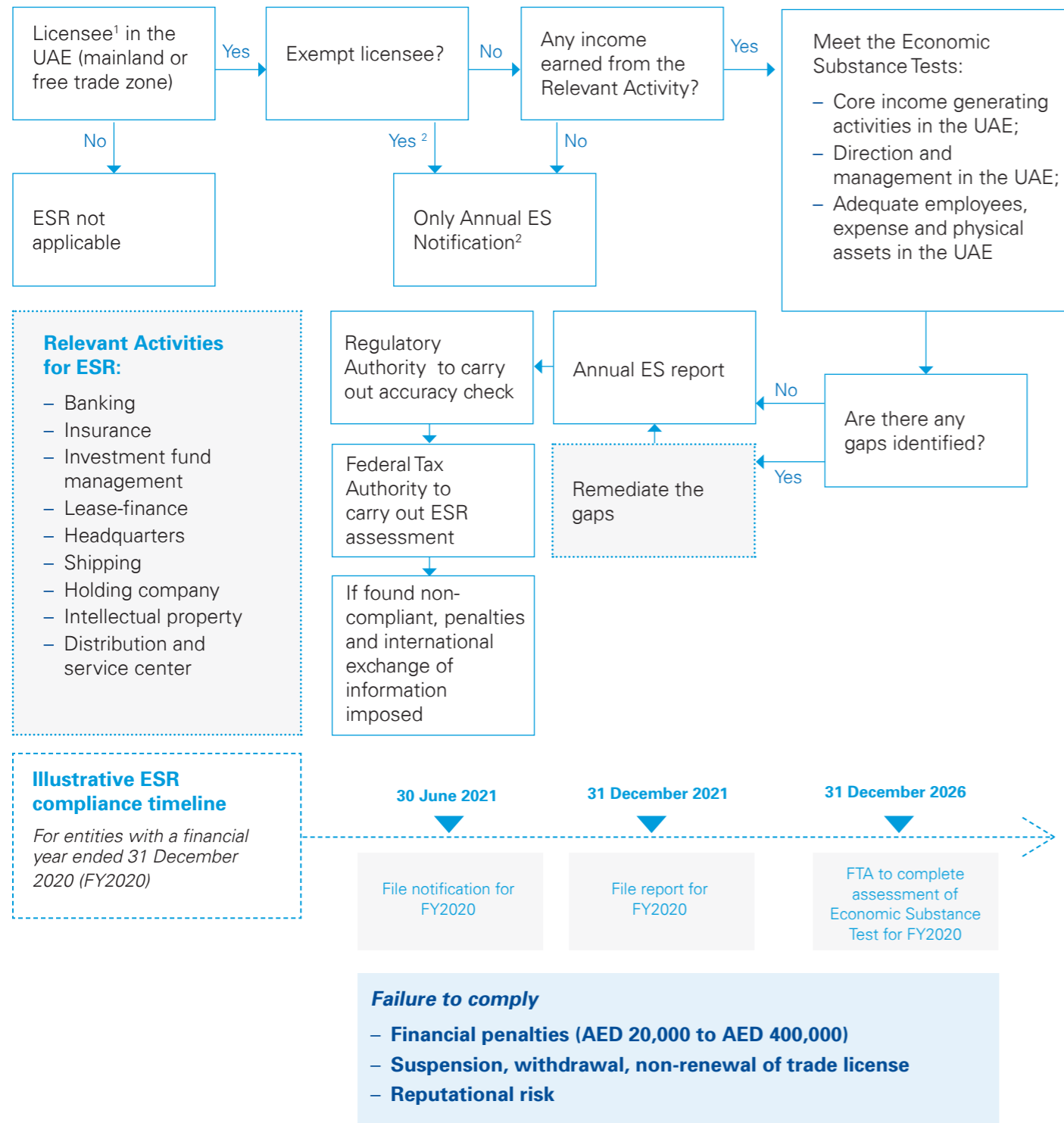
Identify gaps between existing substance and the level of substance required under ESR and advise on remedial measures



Assistance in responding to inquiries from the regulatory authorities/FTA



ESR – In a nutshell



¹ Embedded in the definition of a 'licensee' or an 'exempt licensee' under ESR is one that carries on a Relevant Activity.

² Exempted licensees must only file a notification and attach supporting documents, with evidence of their exempt status.

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