

## UAE issues FAQs on Economic Substance Regulations

### Summary

Further to the issuance of [Cabinet of Ministers Resolution No. 31](#) of 2019 concerning Economic Substance Regulations ('ESR'), [Ministerial Decision No. 215 for the year 2019](#) providing additional guidance on ESR ('additional guidance'), and [Cabinet Resolution No. 58 of 2019](#) determining the Regulatory Authorities (refer our previous alerts<sup>1</sup> for more details), the UAE Ministry of Finance ('MoF') has, on 5 January 2020, published 41 [Frequently Asked Questions \('FAQs'\)](#) on their website for the implementation of ESR in the UAE. The FAQs are structured under the following categories:

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|--|---|
| A. The ESR;  | F. Holding Company Business;            |
| B. Scope of application;                                     | G. "High Risk" IP Business;             |
| C. Demonstrating economic substance in the UAE;              | H. Investment Fund Management Business; |
| D. Demonstrating economic substance in the UAE- outsourcing; | I. Lease-Finance Business;              |
| E. Distribution and Service Centre Business;                 | J. Headquarter Business; and            |
|  | K. Administration.                      |

Although guidance with respect to the format and mechanism for filing ESR notifications (starting from 1<sup>st</sup> January 2020 onwards) and report (due by 31<sup>st</sup> December 2020<sup>2</sup>) is yet to be formally issued by the respective Regulatory Authorities (with the exception of RAK ICC), these FAQs provide certain clarifications including the following:

- Applicability of ESR to UAE headquartered groups (as opposed to foreign headquartered groups only) and offshore free zone companies;

<sup>1</sup> [UAE issues economic substance regulations effective 30 April 2019](#), [UAE issues additional guidance on economic substance regulations](#) and [UAE Economic Substance Regulations – Regulatory Authorities notified](#).

<sup>2</sup> For the financial year ended 31<sup>st</sup> December 2019



- Notification requirement for exempt entities undertaking relevant activities (i.e. 51% government-owned entities);
- Compliance obligations by Licensees that are part of the same group on an **individual** basis rather than a consolidated basis;
- Looking beyond trade licenses to the actual activities (i.e. substance over form) in determining whether an entity performs a Relevant Activity;
- Intra-group lending for consideration to be regarded as “Lease Finance Business”; and
- Specific guidance on certain Relevant Activities (Distribution and Service Centre Business, Holding Company Business, Headquarter Business, Investment Fund Management, Lease-Finance and High-Risk IP Business).

### Key Clarificatory Points

We have tabulated below the key clarificatory points in the FAQs.

Topic	FAQ Reference	Guidance and Our Comments
<b>B. Scope of application</b>		
Applicability of ESR to UAE headquartered entities	6	<p>ESR applies to any UAE entity that carries on a Relevant Activity, irrespective of whether it is part of a UAE headquartered group or foreign multinational group or owned by foreign and/ or local shareholders in UAE.</p> <p><b>Our Comments</b></p> <p>This clarifies a key concern of many UAE headquartered entities that were previously deliberating the applicability of ESR to them considering they are headquartered in the UAE and hence have significant substance in the UAE.</p>
Applicability of ESR to offshore free zone companies	7	<p>ESR would apply to any offshore free zone company that undertakes a Relevant Activity.</p>
Role of trade license in determining whether a Licensee undertakes a Relevant activity	8	<p>The Licensee must look at the activities actually undertaken (rather than what is stated in the commercial license) during a financial period to determine whether or not it is undertaking a Relevant Activity. A substance over form approach has been emphasised.</p>
Notification requirement for entities that do not undertake a Relevant Activity during a financial period	10	<p>Licensees which do not undertake a Relevant Activity during the financial period are not required to make an ESR notification.</p> <p><b>Our Comments</b></p> <p>Even if an entity is licensed to carry out a Relevant Activity as per their Trade License but has not actually undertaken that activity during the concerned financial period (and accordingly has not earned any income therefrom), the entity is not required to file an ESR notification.</p> <p>A prudent view, previously being considered by UAE businesses, was to file a notification if the License specified a Relevant Activity, even if it was not being undertaken by the entity.</p>



Topic	FAQ Reference	Guidance and Our Comments
<b>C. Demonstrating economic substance in the UAE</b>		
Assessment of Licensees that are part of the same group	14	This clarifies that Licensees that are part of the same group <b>cannot</b> be aggregated for economic substance purposes. Each Licensee would need to comply with the ESR and demonstrate substance on an individual basis. However, such UAE entities can demonstrate substance (staff, assets, premises) along with other UAE group entities provided there is a documented agreement as required under the outsourcing provisions.
UAE Tax Residency Certificate as proof of meeting the Economic Substance test	19	This clarifies that obtaining a UAE Tax Residency Certificate in itself is <b>not proof</b> of a Licensee having adequate economic substance in the UAE.
<b>D. Demonstrating economic substance in the UAE- outsourcing</b>		
What can a Licensee outsource	20	A Licensee can outsource any or all of its Core Income Generating Activities' ('CIGA') so long as the outsourced activities are performed in the UAE. Thus, a Licensee can use UAE based (i) employees and (ii) physical assets (including premises) of third parties or related entities to satisfy the Economic Substance Test. A Licensee cannot outsource "directed and managed", as the Licensee is required to demonstrate oversight and control of its Relevant Activity in the UAE.
Outsourcing activities to a foreign person	23	Activities that are not CIGA (e.g. back office functions) can be outsourced to foreign third party or related party service providers.
<b>E. Distribution and Service Centre Business</b>		
Distribution and Service Centre	24	<p>It is clarified that a "Distribution and Service Centre" Business refers to two distinct activities that are covered under one "Relevant Activity" heading. In addition to reiterating the definition of a Distribution and Service Centre Business, this clarifies that Licensees engaged in other Relevant Activities (Banking, Insurance, Investment Fund Management, Lease-Finance, Shipping, or Headquarter Business) that purchase goods and/ or provide services to foreign group companies as a normal part of their business operations, would not be considered to be engaged in a Distribution and Service Centre Business to prevent duplicate reporting. However, notification and reporting under the other Relevant Activity will still be required.</p> <p><b>Our Comments</b></p> <p>Article 3.3 of the additional guidance states that "A Licensee that carries one or more than one Relevant Activity is required to satisfy the Economic Substance Test for each Relevant Activity carried on by such Licensee." However, in light of FAQ# 24, businesses undertaking Relevant Activities, as mentioned therein, need not satisfy the "Distribution and Service Centre" test. In other cases, however, in line with the aforesaid provision of the additional guidance, an entity undertaking multiple Relevant Activities would need to meet the Economic Substance test in respect of each activity.</p>



Topic	FAQ Reference	Guidance and Our Comments
<b>I. Lease-Finance Business</b>		
Lending to another group entity	32	UAE entities (other than Banking, Insurance, and Fund Management Business) that provide loans or other forms of credit for consideration to UAE or foreign group companies would be considered to be engaged in Lease-Finance Business. Provision of interest-free loans would be outside the scope of the 'Lease-Finance Business' definition.
<b>K. Administration</b>		
Notification requirement	38	<p>Licensees undertaking a Relevant Activity (irrespective of whether the Licensee qualifies for an exemption under the ESR or has earned income from the Relevant Activity during the relevant financial period), must submit a notification with its Regulatory Authority.</p> <p><b>Our Comments</b></p> <p>This indicates that Licensees in which the government has at least 51% direct or indirect ownership (i.e. that qualifies for the exemption under the ESR) may also be required to notify if they undertake Relevant Activities. This seems to read contrary to the following provisions:</p> <ul style="list-style-type: none"> <li>Article 3(2) of the ESR which states that <i>'The provisions of this Resolution shall not apply to any commercial company (as defined in Article 1 of the Commercial Companies Law) in which the Government of the State, or the Government of any Emirate of the State, or any governmental authority or body of any of them has any direct or indirect ownership in its share capital.'</i></li> <li>Article 3.2 of the additional guidance which states that <i>"Companies in which the Federal Government or the Government of any Emirate of the State, or any governmental authority or body of any of them which has at least 51% direct or indirect ownership in its shareholding are not subject to the ESR."</i></li> </ul> <p>Accordingly, 51% or more government-owned entities undertaking any Relevant Activity should also consider filing notifications.</p>
Penalties for non-compliance	40	In addition to reiterating the penalties in the ESR, the FAQs also clarify and confirm that failure to notify would expose the defaulter to a penalty ranging from AED 10,000 to AED 50,000.

### Guidance/ details awaited

The MoF is yet to provide guidance on how to complete and file Economic Substance Reports and most regulatory authorities are yet to determine ESR notification filing mechanisms and deadlines. Considering that the additional guidance provides that notifications would be due for the first applicable period (1<sup>st</sup> January 2019 to 31<sup>st</sup> December 2019) from 1<sup>st</sup> January 2020, it is expected that guidance on notifications would be issued by all Regulatory Authorities shortly.



If you would like to discuss the above in more detail and understanding the specific implications of the developments to your business, please feel free to get in touch with:

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