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# ECONOMIC SUBSTANCE REGULATIONS

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## ECONOMIC SUBSTANCE REGULATIONS

### Background

The United Arab Emirates (UAE) introduced Economic Substance Regulations (ESR) to honor its commitment, as a member of the Organization for Economic Cooperation and Development (OECD), about OECD inclusive Framework on Base Erosion and Profit Shifting (BEPS), and in response to a review of the UAE tax framework by the European Union (EU) which resulted in the UAE being included on the EU list of non-cooperative jurisdictions for tax purposes.

In this background, the UAE on April 30, 2019 issued ESR through Cabinet of Ministers Resolution No. 31 of 2019. The purpose of the ESR is to ensure that UAE entities that undertake certain activities are not used to artificially attract profits that are not commensurate with the economic activity undertaken in the UAE.

### ESR and Related Documents

Alongside the Cabinet of Ministers Resolution No. 31 of 2019 following further documents have been issued:

- Ministerial Decision No. 215 for the Year 2019 on Issuance of Directives for the Implementation of the Provisions of the Cabinet of Ministers Resolution No. 31 of 2019 (the Directives).
- The Cabinet Resolution No. 58 of 2019, determining the Regulatory Authorities concerned with the Cabinet of Ministers Resolution No. 31 of 2019 (the Regulatory Authorities).
- The Relevant Activities Guide (the Guidelines).

### What ESR Requires

ESR requires that a Licensee must meet the Economic Substance-

Test as per Article 6(2) of ESR is met in the following cases:

- a. The Licensee conducts State (UAE) Core Income-Generating Activity in the UAE.
- b. The Licensee is directed and managed in the UAE in relation to that activity, if following conditions are met:

The Licensee's board of directors meets in the UAE at an adequate frequency having regard to the amount of decision-making required at that level.

At such board meetings, there is a quorum of directors physically present in the UAE.

The meetings are recorded in written minutes and signed by the directors attending the meetings.

The minutes, of such board meetings, record the making of strategic decisions of the Licensee at the meeting.

The directors of the Licensee have the necessary knowledge and expertise to discharge the duties of the board.

The minutes of all board meetings and the records of the Licensee are kept in the UAE.

In the case of branch offices and representative offices of foreign companies and other commercial companies that do not have a board of directors but rather are managed and operated by a single manager, such manager shall be physically present in the UAE when taking key decision relating to the management and operation of these entities.

- c. having regard to the level of Relevant Activity, if there is an adequate number of qualified full-time employees in relation to that activity who are physically present in the UAE (whether or not employed by the Licensee or by another entity and whether on temporary or long-term contracts), or adequate level of expenditure on outsourcing to third party service providers, whose activities, employees, expenditure, and premises are in the UAE; and these activities, employees, expenditures and premises are adequate for carrying out the Relevant Activity being outsourced.

- d. if there is adequate operating expenditure incurred by it in the UAE, or adequate level of expenditure on outsourcing to third party service providers whose activities, employees, expenditure and premises are in the UAE; and these activities, employees, expenditures and premises are adequate for carrying out the Relevant Activity being outsourced.
- e. if there are adequate physical assets in the UAE or adequate level of expenditure on outsourcing to third party service providers in the UAE, for the activities of the Licensee;
- f. in the case of State (UAE) Core Income-Generating Activity carried out for the relevant Licensee by another entity, if it is able to monitor and control the carrying out of that activity by the other entity.

In case of Holding Company Business (one of the Relevant Activity), that derives its income from dividends and capital gains only, the Economic Substance Test is met if following conditions are met:

Complies with the requirement to submit any documents, records or information to the relevant Regulatory Authority in accordance with the law applicable to the Licensee in the UAE.

Has adequate employees and premises for holding and managing the Holding Company Business.

Licensee is defined, in ESR as, a natural or juridical person licensed by the competent licensing authority/ authorities in the State (UAE) to carry out a Relevant Activity in the State (UAE), including a Free Zone and a Financial Free Zone.

Relevant Activity means any of the activities set out at Article 4 of the ESR, as follows:

- Banking Business
- Insurance Business
- Investment Fund Management Business
- Lease-Finance Business
- Headquarters Business
- Shipping Business
- Holding Company Business

- Intellectual Property Business
- Distribution and Service Centers Business

State Core Income-Generating Activities, as per Article 5 of the ESR, in respect of each of the Relevant Activity are as follows:

Relevant Activity	State Core Income-Generating Activities
Banking Business	<ul style="list-style-type: none"> <li>• raising funds, managing risk including credit, currency and interest risk.</li> <li>• taking hedging positions.</li> <li>• providing loans, credit or other financial services to customers.</li> <li>• managing capital and preparing reports to investors or any government authority with functions relating to the supervision or regulation of such business.</li> </ul>
Insurance Business	<ul style="list-style-type: none"> <li>• predicting and calculating risk.</li> <li>• insuring or re-insuring against risk and providing Insurance Business services to clients.</li> <li>• Underwriting insurance and reinsurance.</li> </ul>
Investment Fund Management Business	<ul style="list-style-type: none"> <li>• taking decisions on the holding and selling of investments</li> <li>• calculating risk and reserves.</li> <li>• taking decisions on currency or interest fluctuations and hedging positions.</li> <li>• preparing reports to investors any government authority with functions relating to the supervision or regulation of such business.</li> </ul>
Lease-Finance Business	<ul style="list-style-type: none"> <li>• agreeing funding terms.</li> <li>• identifying and acquiring assets to be leased (in the case of leasing).</li> <li>• setting the terms and duration of any financing or leasing.</li> <li>• monitoring and revising any agreements.</li> <li>• managing any risks.</li> </ul>
Headquarters Business	<ul style="list-style-type: none"> <li>• taking relevant management decisions.</li> <li>• incurring operating expenditures on behalf of group entities.</li> <li>• coordinating group activities.</li> </ul>

Shipping Business	<ul style="list-style-type: none"> <li>• managing crew (including hiring, paying and overseeing crew members).</li> <li>• overhauling and maintaining ships.</li> <li>• overseeing and tracking shipping.</li> <li>• determining what goods to order and when to deliver them, organising and overseeing voyages.</li> </ul>
Holding Company Business	<ul style="list-style-type: none"> <li>• all activities related to that business; and in respect of Holding Company Business that derives income from other sources other than dividends and capital gains from its equity interest, the state Core Income-Generating Activities shall be those activities associated with the income generated.</li> </ul>
Intellectual Property Business	<ul style="list-style-type: none"> <li>• taking strategic decisions and managing (as well as bearing) the principal risks related to development and subsequent exploitation of the intangible asset generating income.</li> <li>• taking the strategic decisions and managing (as well as bearing) the principal risks relating to acquisition by third parties and subsequent exploitation and protection of the intangible asset.</li> <li>• carrying on the ancillary trading activities through which the intangible assets are exploited leading to the generation of income from third parties.</li> </ul>
Distribution and Service Centers Business	<ul style="list-style-type: none"> <li>• transporting and storing component parts, materials or goods ready for sale.</li> <li>• managing inventories.</li> <li>• taking orders.</li> <li>• providing consulting or other administrative services.</li> </ul>

### Reporting Requirements

1. A Notification (to the Regulatory Authority), under Article 8(1) of the ESR, at the time and the manner and Form approved by the relevant Regulatory Authority.
2. An annual report (to the Regulatory Authority) to satisfy the Economic Substance Test, under Article 8(2) of the ESR, no later than twelve months after the last day of the end of each financial year of the Licensee.

## Penalties

The ESR provides following penalties for non-compliance:

• Failure to meet the Economic Substance Test (First Time)	• Between AED 10,000 to AED 50,000
• Failure to meet the Economic Substance Test (Subsequent)	• Between AED 50,000 to AED 300,000
• Failure to provide Information/Provision of Inaccurate Information	• Between AED 10,000 to AED 50,000

In addition, the relevant Regulatory Authority may impose any other administrative action like suspension, revocation or non-renewal of the license of the Licensee.

## Exemption

The ESR is not to apply to any commercial company, as defined in Article 8 of Federal Law No. 2 of 2015 concerning Commercial Companies, in which the Federal Government, the Government of any Emirate of the UAE, any Government Authority or entity affiliated to either of them owns directly or indirectly at least fifty one percent (51%) of the share capital.

## Regulatory Authorities

The Regulatory Authorities are as follows in respect of each of the Relevant Activity:



Relevant Activity	Regulatory Authority
Banking Business	<ul style="list-style-type: none"> <li>• UAE Central Bank</li> <li>• The competent authority in the Financial Free Zone for the Banking Businesses</li> </ul>
Insurance Business	<ul style="list-style-type: none"> <li>• Insurance Authority</li> <li>• The competent authority in the Free Zone and Financial Free zone for the Insurance Business</li> </ul>
Investment Fund Management Business	<ul style="list-style-type: none"> <li>• Securities and Commodities Authority</li> <li>• The competent authority in the Free Zone and Financial Free zone for the Investment Fund Management Business</li> </ul>
Lease-Finance Business	<ul style="list-style-type: none"> <li>• UAE Central Bank</li> <li>• The competent authority in the Free Zone and Financial Free zone for the Lease-Finance Business</li> </ul>
Headquarter Business	<ul style="list-style-type: none"> <li>• Ministry of Economy</li> <li>• The competent authority in the Free Zone and Financial Free zone for the Headquarter Business</li> </ul>
Shipping Business	<ul style="list-style-type: none"> <li>• Ministry of Economy</li> <li>• The competent authority in the Free Zone and Financial Free zone for the Shipping Business</li> </ul>
Holding Company Business	<ul style="list-style-type: none"> <li>• Ministry of Economy</li> <li>• The competent authority in the Free Zone and Financial Free zone for the Holding Company Business</li> </ul>
Intellectual Property Business	<ul style="list-style-type: none"> <li>• Ministry of Economy</li> <li>• The competent authority in the Free Zone and Financial Free zone for the Intellectual Property Business</li> </ul>
Distribution and Service Centre Business	<ul style="list-style-type: none"> <li>• Ministry of Economy</li> <li>• The competent authority in the Free Zone and Financial Free zone for the Distribution and Service Centre Business</li> </ul>

Please share your queries & responses

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