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Retrospective amendment to ESR in UAE - Need to Re-assess, Re-notify and Re-build the strategy

As part of the UAE's commitment as a member of the OECD Inclusive Framework, it introduced a Resolution on the Economic Substance (Cabinet of Ministers Resolution No.31 of 2019, the 'Regulations') on 30 April 2019 (hereinafter referred to as the 'Erstwhile Regulations'). The concerned Ministry also released multiple guidance and Frequently Asked Questions (FAQs) for ease of understanding the requirements of the law.

Recently, the Ministry, in an attempt to revamp the Erstwhile Regulation has issued an amended Regulation (vide Cabinet Resolution No 57 of 2020) and guidance (Ministerial Decision No 100 of 2020) that repeals and supersedes the Erstwhile Regulation and guidance with **retrospective** effect. The said amended Regulations are hereinafter referred to as New Regulations.

Notably, the New Regulations have introduced significant amendments to the extent of changing the governance mechanism, scope and applicability, compliance procedure, and also enhanced the quantum of administrative penalties for non-compliance.

This alert summarises the key changes and its possible implications on the compliance requirement of the businesses in the UAE.

Re-asses | Scope and Applicability

Licensee

The Erstwhile Regulation was applicable to all the licensees, whether a natural or juridical person, who has been licensed by the competent authority to carry out an activity in UAE. Whereas, the New Regulation covers private/public shareholding company, joint venture company, partnership firm, etc. In other words, the New Regulation does not cover individuals, sole proprietorship, trust, or a foundation under its ambit.

Exemptions

- Earlier, licensee owned (more than 51%) by Federal or Emirate Government, directly or indirectly, were exempt from Regulation. This exemption has been removed by the New Regulation.

- Additionally, the amended Regulation has enlarged the exemption to the following categories:
  - Investment Fund;
  - A company that is a tax resident of a country outside the UAE;
  - A licensee who is completely domiciled in the UAE (not part of a MNE group and no cross border activities);
  - Branch of a foreign entity which is taxed outside the UAE.
- However, the exemption to the above categories will be applicable only upon submitting evidence to fulfill the conditions prescribed for exemption.

Applicability to Branch

- Earlier, the Regulation required all the licensee (including branches) who have undertaken Relevant Activity to comply with the Regulation.
- The amended Regulation clarifies the compliance requirement for UAE as well as foreign branches as under:
  - **UAE branch of UAE entity –** It is merely an extension of 'parent' or 'head office' and, therefore, not considered as a separate entity for this Regulation.
  - **Foreign branch of UAE entity -** UAE entity is not required to consolidate activities/income of foreign branch for ESR provided that the income of such branch is subject to tax outside the UAE. In this context, the branch includes a Permanent Establishment or any other form of taxable presence for corporate income tax purposes.
  - **UAE branch of a foreign entity -** It is clarified that such an entity is required to comply with Regulation unless the Relevant Income of such branch is subject to tax outside UAE.

Re-validate | Definition of Distribution, Service Center and Intangible transactions

Amendment in Definition of Distribution and Service Centre Business

- Earlier, for an activity to be qualified as a Distribution Business, the following conditions were required to be fulfilled:

  ✓ Purchasing from Foreign Connected Person

  ✓ **Importing and storing in the UAE**

  ✓ Re-selling such component outside the UAE
- The New Regulation has significantly amended the above definition, perhaps for the right reason. The New Regulation has removed the condition for importing/storing in the UAE. Also, the re-selling of goods within the UAE will now qualify as 'Distribution Business' under the New Regulation.
- Similarly, as regards the Service Centre Business, it is now clarified that any services provided to foreign connected persons shall **qualify as the Service Center Business, regardless of the business of the foreign connected person.**
- In effect, the scope of Distribution and Service Center Business has now been enlarged to certain activities that were previously falling outside the definition due to the language of the law.

High-Risk Intellectual Property Licensee

The New Regulations have provided much-needed clarity on this relevant issue, which is at the center of profit shifting in most cases – the intangible-related transactions.
The New Regulations have now clarified that a licensee would be covered under the Regulations if it derives income from licensing or selling of an intellectual property to a foreign-related party. Also, if such an intellectual party was previously acquired from (a) Connected Person or (b) in consideration for funding research and development by another person situated in a foreign country.

Re-Notify | Furnish Notification to Ministry

- Earlier, the notification was required to be filed at the time specified by the Regulatory Authority in the form and manner prescribed by them. It is pertinent to note that most of the businesses in the UAE have already furnished the notifications to their respective Regulatory Authority. The due date in most cases to file such notification with the Regulatory Authority was 30 June 2020 for the financial year ended on 31 December 2019.
- As per the amended Regulation, the notifications must be submitted electronically on the **Ministry of Finance Portal** within six months from the end of the financial year of the licensee.
- Guidelines also clarified that licensees that have already submitted a notification to their Regulatory Authorities would be required to re-submit the notification on the Ministry of Finance portal once the portal is active. At present, no deadline is mentioned for this re-submission.

Re-strategize | More Stringent Administrative Penalties

- The amended Regulation has increased the administrative penalty in certain offenses. We have summarized the administrative penalties as under:

Offense	As per original Regulation (in AED)	As per amended Regulation (in AED)
Failure to notify/ filing inaccurate particulars	10000 to 50000	20000
Failure to meet substance test (First Year)	10000 to 50000	50000
Failure to meet substance test (Subsequent Year)	300000	400000

- Additionally, in certain cases, the penalty included sharing of information with foreign competent authority as well as suspension/cancellation of license.

Changes in the Governance Mechanism

Regulatory Authority and National Assessing Authority

- The Erstwhile Regulation/Ministerial Guidance suggested that the ESR report was to be furnished to various Regulatory Authorities within the UAE, depending upon the type of Relevant Activities.
- Under the New Regulation, the Ministry has appointed Regulatory Authorities for different Relevant Activities, and at the same time, it has appointed Federal Tax Authority ('FTA') as National Assessing Authority.
- It has been clarified that the role of the Regulatory Authorities is mainly to collect/verify information/ documents from the licensees, whereas National Assessing Authority is required to undertake the assessment for determining Economic Substance Test, imposing a penalty, or hearing appeals.

Exchange of Information

- The Erstwhile Regulation specified that Information should be exchanged with foreign competent authorities under the following circumstances:
  ✓ Licensee fails to satisfy substance test
  ✓ Licensee is High-Risk IP Licensee
- In addition to the above, the amended Regulation has also included a circumstance for exchanging information when an entity/ branch of a foreign entity claims to be a tax resident outside the UAE.

Way Forward

With less than four months to the statutory due date for furnishing the first annual economic substance report for most businesses in UAE, the Ministry, by making a retrospective amendment to the Regulation, has, in a way, pushed the licensees to re-test, re-notify, and re-strategize the existing position.

When most of the businesses were busy in preparing/ collating information for preparing annual ESR report (due in December 2020), this additional exercise of re-assessing the applicability of Regulation will increase the compliance burden.

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