



Insights: UAE economic substance requirements

May 2020

KPMG Lower Gulf Limited

Core income-generating activities (CIGAs) under each relevant activity

On 15 April 2020, the UAE Ministry of Finance (MoF) released the Relevant Activities Guide (RAG) to aid UAE businesses in understanding the scope and coverage of listed economic activities and their associated Core Income Generating Activity (CIGA).

Summary

The UAE introduced Economic Substance Requirements on 30 April 2019, which are applicable as of 1 January 2019. A guidance on the application of the Regulations was subsequently issued on 11 September 2019.

With the release of the RAG on 15 April 2020, the Ministry of Finance continues their efforts to clarify the scope and coverage of the Regulations, specifically with respect to the listed economic activities and their associated CIGAs.

The RAG also provides several examples of typical scenarios for each relevant activity observed in the market, and encourages organizations to seek professional advice if a business is unable to determine whether it conducts a relevant activity.

Introduction

Pursuant to Cabinet of Ministers Resolution No. 31 of 2019 dated 30 April 2019, the UAE introduced the Economic Substance Regulations (the Regulations) which require in-scope UAE entities (Licensees) to locally maintain 'economic substance' in line with the level and type of activity they undertake. The Regulations are in effect from 30 April 2019.

On 4 September 2019, the regulatory authorities for the purposes of the Regulations were determined pursuant to the issuance of Cabinet Resolution No. 58 of 2019. The MoF issued a directive for implementation of the Regulations via Ministerial Decision No. 215 dated 11 September 2019 (the Guidance). The MoF also published frequently asked questions (FAQs) on its website² to provide further clarity and practical guidance on the application of the Regulations.

The RAG, which should be read in conjunction with the Regulations, the Guidance and the FAQs, sheds light on several issues which have been the topics of discussions amongst professional service providers and UAE entities operating across various business sectors.

This tax alert provides a summary of the RAG, our observations and outlines the next steps that need to be taken by the Licensees in the UAE.

Detailed discussions

Based on the RAG, the MoF has reiterated that the Regulations apply to Licensees which are carrying out any of the following nine relevant activities, which should be determined using the 'substance over form' approach



Licensees are not required to be actively engaged in any of the above business categories for it to be considered as carrying on a relevant activity. This means that even the passive receipt of income under a finance lease would be considered as carrying on a Lease- Finance business.

When a Licensee undertakes multiple relevant activities during the financial period, it will be required to demonstrate substance for each relevant activity, unless the activity is considered ancillary to the main relevant activity (materiality test). Under certain circumstances, consolidated reporting of an ancillary activity could prevent duplicate reporting and, subject to the fact pattern, may be plausible for banking, lease-finance, headquarters and distribution and service centre operations.

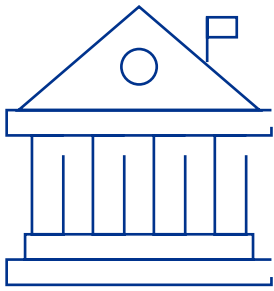
The RAG seems to suggest that demonstration of economic substance for a particular economic activity is required only if any gross income was generated from such economic activity during the financial period, irrespective of the form in which income was realized.

In order to demonstrate economic substance, actual undertaking of CIGA and a majority of the key decision makers of the CIGA must be present in the UAE. However, performance of all CIGAs set out in the Regulations is not required (note that the list of CIGAs list is not exhaustive and could include others).

What is 'substance over form'?

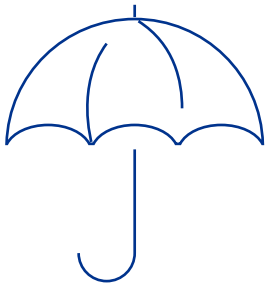
This approach requires Licensees to take into consideration all activities they have performed, irrespective of the ones stated on the respective business licenses issued by UAE licensing authorities (free trade zone or otherwise).

Core income-
generating
activities (CIGAs)
under each
relevant activity



Banking business

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| Definition | <p>Business of accepting deposits of money which may be withdrawn, or that are repayable on demand or after a fixed period, or after notice, by cheque or otherwise, and the use of such deposits, either in whole or in part, in:</p> <ul style="list-style-type: none">a) the making or giving of loans, advances, overdrafts, guarantees or similar facilities; orb) the making of investments, <p>for the account and at the risk of the Licensee.</p> |
| In-scope entities | <p>UAE entities that are licensed as a 'commercial bank', or an equivalent licensing category that allows for the acceptance of deposits, by any of the following regulatory authorities:</p> <ul style="list-style-type: none">– The Central Bank (for Licensees established in mainland UAE)– The Dubai Financial Services Authority, or DFSA (for Licensees established in the Dubai International Financial Centre, or DIFC)– Financial Services Regulatory Authority, or FSRA (for Licensees established in the Abu Dhabi Global Market, or ADGM) |
| Potential exclusions | <ul style="list-style-type: none">– Licensees that are part of a banking group and only provide advisory, arranging and other services to clients of the banking group– UAE businesses engaged in foreign currency exchange and money remittances– Financial intermediaries in the sale and purchase of domestic and foreign stocks and bonds, currencies and commodities and money market transactions <p>However, the above businesses/Licensees should consider whether they undertake another relevant activity.</p> |
| CIGAs | <ul style="list-style-type: none">– Raising funds (aside from accepting the public's deposits), managing risk including credit, currency and interest risk – raising capital, issuing bonds or going to the money markets. "Risk management activities" are aimed at ensuring the capital base of the Licensee is not eroded and to control the cost of funds. The key functions and related decision-making in respect of these activities are expected to be performed in the UAE.– Taking hedging positions – Risk mitigation by taking opposing or offsetting positions. The Licensee must be able to demonstrate that the related activities and decisions making take place in the UAE.– Providing loans, credit or other financial services to customers – Refers to lending or investing the deposits of its customer (i.e. individuals, corporations and other financial institutions) and other available funds.– Managing capital and preparing reports to investors or any government authority with functions relating to the supervision or regulation of such business – The banking sector is highly regulated and involves various reporting to regulators and investors. The Licensee is expected to perform and oversee its reporting related functions and activities in the UAE. |



Insurance business

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| Definition | Accepting risks by effecting or carrying out contracts of insurance, in both the life and non-life sectors, including contracts of reinsurance and captive insurance arrangements. |
| In-scope entities | UAE entities that are regulated by any of the following regulatory authorities: <ul style="list-style-type: none">– UAE Insurance Authority (for Licensees established in mainland UAE)– DFSA (for Licensees established in the DIFC)– FSRA (for Licensees established in ADGM) |
| Potential exclusions | Insurance brokers, agents, and other UAE businesses providing insurance-related services that do not involve assuming all or some of the insured risk However, the above businesses/Licensees should consider whether they undertake another relevant activity. |
| CIGAs | <ul style="list-style-type: none">– Predicting and calculating risk – Involves determining the quantification and likelihood of the insured event occurring and the likely costs, ensuring that the premiums charged are commensurate with the risks accepted.– Insuring or re-insuring against risk and providing Insurance Business services to clients – Includes insuring policyholders against specific risks and providing reinsurance to primary insurers.– Underwriting insurance and reinsurance – Refers to the evaluation and analysis of the risks of an insurance policy and establishing the pricing for accepted insurable risks. |



Investment fund management business

Definition

Provision of discretionary investment management services in relation to domestic or foreign investment funds. Discretionary investment management services encompass making an investment, divestment and risk-related decisions on behalf of an investment fund.

In-scope entities

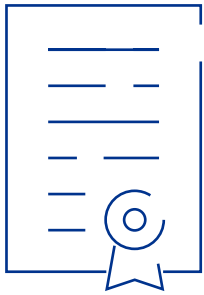
- Self-managed funds (i.e. the investment manager and the investment fund are part of the same entity).
- The investment fund manager, with respect to an investment fund structured as a partnership has both a corporate general partner and an investment fund manager, provided that the general partner does not undertake business activities save its role as a general partner of the investment fund.

Potential exclusions

- Investment fund that is not a self-managed fund; potential GP exclusions

CIGAs

- **Taking decisions on the holding and selling of investments** – Involves the independent consideration, deliberation and making of investment and divestment decisions. Please note that a Licensee that is considered to not be carrying on this CIGA if such Licensee is merely implementing decisions (with respect to the holding and selling of investments) of another entity without independent evaluation before taking steps or decisions to effect the investment or divestment decisions taken. Also, the majority of the key decision makers should be physically present in the UAE when the decisions are made.
- **Calculating risk and reserves** – Pertains to activities in respect of risks for the investment fund as a whole, as opposed to isolated risk calculations for one area of applicable risk that does not take into account all relevant risks applicable to the investment fund and the reserves required on a holistic basis.
- **Taking decisions on currency or interest fluctuations and hedging positions** – Relates to the requisite activities undertaken to determine if the investment fund is exposed to, or if it is in the best interests of the investment fund to enter into, hedging arrangements against currency or interest fluctuations, and taking relevant decisions regarding those determinations. This CIGA should be holistically carried out by the investment fund manager, taking the investment fund's overall position into consideration. Isolated decisions involving specific investments would not suffice for the purposes of meeting this CIGA.
- **Preparing reports to investors or any government authority with functions relating to the supervision or regulation of such business** – Although a Licensee is not required to perform the administrative task of compiling the various routine annual or quarterly reports, a Licensee is expected to perform the following:
 - Oversee this CIGA from the UAE and ensure that the necessary systems and processes are in place (i.e. contractual arrangement with any third-party administrator)
 - Be ultimately responsible for the reporting, and to possess the necessary understanding and knowledge to accurately convey the position of the investment fund(s) at any time



Lease-finance business

Definition

Offering credit or financing for any kind of consideration, including intra-group financing

Offering credit or financing includes:

- Making loans to related or third parties
- Entering into finance leases in relation to assets (other than land)
- Providing credit in the form of hire purchase agreements, long term credit plans, and other types of financing arrangements

What is 'consideration'?

- Interest
- Origination and processing fees
- Gains arising from conversion of a loan into share capital of the debtor
- Penalties for late payment

Exclusions:

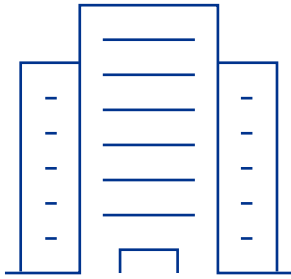
- Granting of security in favor of the lender
- Interest on late payment of trade invoices

Potential exclusions

- Providing credit where there is no consideration expected at the time it is provided
- Investment in bonds or similar securities or debt instruments that are traded on a regulated exchange
- Commercial leasing of properties for consideration (e.g. rent)

CIGAs

- **Agreeing funding terms** – Relates to the funding of the Licensee itself, and includes agreeing the type of funding (e.g. equity, preference shares, debt, etc.), the quantum of funding, the currency, the rates of interest payable, the security given (if any), and any covenants.
 - **Identifying and acquiring assets to be leased (in the case of leasing)** – Pertains to the activity of identifying and verifying suitable assets to purchase and then rent to a hirer or lessee for an agreed period, including negotiating the acquisition and the terms of the supply of the assets to be leased or hired
 - **Setting the terms and duration of any financing or leasing** – The Licensee is expected to have the authority (within certain parameters, where applicable) and undertake the negotiation of the amount of financing or leasing to be provided, the financial and other terms and conditions, and the relevant legal agreements to be entered into.
 - **Monitoring and revising any agreements** - This includes obtaining data about a borrower or lessee (or the group to which they belong), testing compliance against covenants, extending the duration or the changing of other terms of the financing provided, and ensuring all relevant information is fed into the decision making process and any amended financing terms.
 - **Managing any risks** – Refers to activities in relation to debt collection, monitoring and maintaining the conditions of the underlying leased assets (in the case of leasing), entering into swap and hedging arrangements, and developing and implementing strategies to reduce or spread risks.
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Headquarters business

Definition

Provision of services to foreign group companies, whereby through the provision of such services, the Licensee either:

- a) takes on the responsibility for the overall success of the group; or
- b) takes on the responsibility for an important aspect of the overall group's performance

For both (a) and (b) above, the Licensee must undertake the following:

- the provision of senior management;
- the assumption or control of material risk for activities carried out by foreign group companies; or
- substantive advice in relation to the assumption or control of such risks.

Other key considerations

- A Licensee's position in its group corporate structure is irrelevant for determining
- whether it is engaged in a headquarters business.

CIGAs

- **Taking relevant management decisions** – Making decisions on the substantive functions and significant risks for group companies, such as decisions on material acquisitions and purchases, the group companies' sales and marketing strategy, product development, business process standardization, etc. the majority of the key decision makers should be physically present in the UAE when the decisions are made.
 - **Incurring operating expenditures on behalf of group entities** – Includes engaging specialist advice or procuring technology on behalf of the group as a whole or purchasing significant assets or specific services for or on behalf of group companies.
 - **Coordinating group activities** – Refers to ensuring that activities such as marketing, HR, IT, finance, tax, etc. are coordinated and organized in a way that produces the best outcome for the group as a whole as opposed to individual group companies.
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Shipping business

Definition

Operating one or more ships in international traffic for the transport of either passengers, cargos or both.

This includes the following activities which are undertaken by a Licensee in connection with the business of operating one or more ships in international traffic:

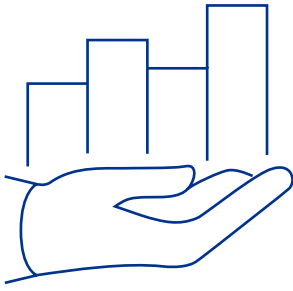
- the rental on a charter basis of ships
- the sale of tickets or similar documents
- the use, maintenance or rental of containers
- the management of the crew of ships.

Potential exclusions

- Operations of the following types of vessels (which do not fall under the definition of a 'ship' for the purposes of the regulations):
 - Fishing vessels
 - Small vessels (i.e. with tonnage not exceeding ten tons)
 - Leisure vessels (e.g. cruise ships and private yachts)
- Chartering of ships on a bareboat basis (but the Licensee needs to consider whether this would fall within the scope of a lease-finance business, depending on the terms of the bareboat charter arrangement)
- Travel/international shipping agencies
- Entities that arrange for their own or other businesses' goods to be transported overseas by sea (unless the relevant ships are being operated by such entities themselves)

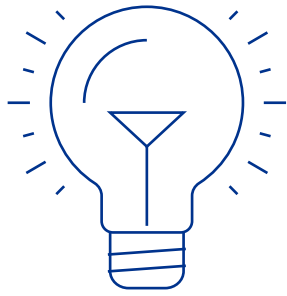
CIGAs

- **Managing crew (including hiring, paying and overseeing crew members)** – Includes the sourcing, recruitment, selection, deployment, scheduling, training, and on-going management of the crew deployed on the vessels, including the associated administration (payroll, insurance, tax and social security withholding) and logistics (travel arrangements, temporary accommodation, etc.).
 - **Overhauling and maintaining ships** – Involves having responsibility for, and the related decision making in respect to the lifting of vessels from the water for maintenance and the general maintenance of ships.
 - **Overseeing and tracking shipping** – Refers to the management and oversight of the logistical aspects of the international transportation of cargo and passengers by ship, including overseeing and managing ship movements.
 - **Determining what goods to order and when to deliver them, organizing and overseeing voyages** – Involves activities to determine how a ship is to be utilized, the types of cargo acceptable and the scheduling of the delivery of such cargos, managing the logistical aspects of the operation of ships, determining which routes to use, and ensuring necessary contingency arrangements are in place.
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Holding company business

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| Definition | <p>A business that:</p> <ul style="list-style-type: none">a) is a holding company in accordance with the law applicable to the Licensee carrying out such activityb) has as its primary function the acquisition and holding of shares or equitable interests in other companiesc) does not carry on any other commercial activity |
| What are 'equity interests'? | <p>Shares in a company and interests in an incorporated partnership, as well as any other instrument which gives the Licensee a beneficial ownership interest in a company</p> |
| Other key considerations | <ul style="list-style-type: none">- A Licensee that is purely engaged in holding company business would only be required to meet the reduced economic substance requirements, as under:<ul style="list-style-type: none">- Comply 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 state- Have adequate employees and premises for holding and managing the holding company business |
| CIGAs | <ul style="list-style-type: none">- All activities related to acquiring and holding shares/equity interests in other companies, subject to the requirement that such activities do not fall within the scope of another relevant activity |



Intellectual Property (IP) business

Definition

Holding, exploiting, or receiving gross income from IP assets

What is an IP Asset' for the purposes of the Regulations?

Any intellectual property right in intangible assets, such as copyrights, patents, trademarks, brands, and technical know-how, from which the Licensee earns separately identifiable income in the form of royalties, license fees, franchise fees, capital gains and any other income from the sale or exploitation of the IP asset

Other key considerations

- The regulatory authority would take the necessary actions in case there is an indication that a Licensee has manipulated its gross income to avoid being subject to the economic substance requirements applicable to an IP business.
- A Licensee that owns an IP asset that is merely auxiliary to its main business would not be considered as carrying on an IP business. The RAG implies that the term 'auxiliary' for IP business purposes means holding an IP asset to contribute to or protect the value of the good or services that the Licensee provide, rather than earning separately identifiable income from the IP asset.
- Periodic decisions by non-resident directors, or local staff passively holding intangible assets, will not be capable of demonstrating CIGA for IP business.
- A Licensee carrying on IP business needs to consider if it falls within the definition of a 'high risk IP Licensee'

CIGAs

- **Research and development (for patents and similar assets)** – Includes planning and documentation of new products, processes or services, prototyping, demonstrating, piloting, testing and validation of new or improved technologies, addressing known scientific or technological obstacles, applying research findings or other knowledge for producing or introducing new or improved materials, devices, products, processes, systems, technologies or services, etc.
- **Branding, marketing and distribution (for marketing intangibles, which are intangibles that relate to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned such as trademarks, brands, customer lists and relationships).** This CIGA includes the following:
 - Marketing and branding – Includes advertising, seeking endorsements, artistic design, developing consumer awareness and customer loyalty.
 - Distribution – Relates to the distribution of marketing intangibles through various mediums such as on demand services, business-to-business sectors, integration into IT systems, creating dealership networks and distribution channels and maintaining relationships to aid in the distribution of marketing intangibles.

What is a 'high-risk IP' Licensee?

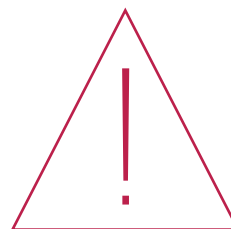
Licensee which carries out IP business, and meets all of the following three requirements:

The Licensee did not create the intellectual property asset which it holds for the purpose of its business

The Licensee acquired the IP asset from either:

- a) A group company, or
- b) In consideration for funding research and development by another person situated in a foreign jurisdiction

The Licensee licenses or has sold the IP asset to one or more group companies, or otherwise earns separately identifiable gross income (e.g. royalties, license fees) from a foreign group company in respect to the use or exploitation of the IP asset



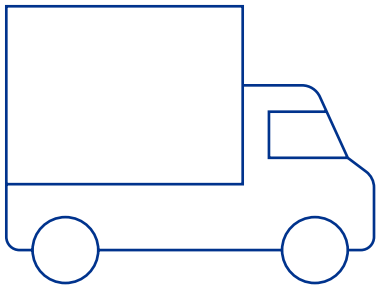
By default, a high-risk IP Licensee is deemed to have failed the economic substance test. This means that the competent authority will exchange the information provided by the high-risk IP licensee with the relevant foreign competent authorities

A high-risk IP Licensee should meet the economic substance test by providing sufficient supporting evidence that it has, and has historically had, a high degree of control over the DEMPE functions (development, enhancement, maintenance, protection and exploitation) of the IP asset

What are the requirements for a high-risk IP Licensee to demonstrate economic substance?

- Have an adequate number of full-time employees, who permanently reside and perform their activities in the UAE, possessing the necessary qualification
- Submit a business plan showing the reasons for holding ownership in the intellectual property asset in the UAE
- Provide information of its employees, showing the level of experience, qualification, duration of employment and the type of contracts entered into by the Licensee with its employees
- Decision making should take place in the UAE





Distribution and service centre business

Definition

“Distribution and service center business” refers to two distinct activities that are covered under one relevant activity. These two distinct activities are as follows:

- Distribution business – Encompasses Licensees that purchase raw materials or finished products from a foreign company group (FCG) and distribute those raw materials or finished goods.
- service center business – Encompasses Licensees that provide consulting, administrative or other services to a foreign group company, and those services are in connection with the FCG’s business outside the UAE.

Potential exclusions

- Licensees that only purchase goods from or distribute goods to third parties
- Licensees that are engaged in the business of providing services to third parties
- Licensees that provide a one-off transaction (i.e. not in the ordinary course of business) to an FCG, and such transaction is recharged to the FCG at cost or less

CIGAs

For a distribution business:

- [Transporting and storing goods, components and materials or goods ready for sale](#) – This encompasses the movement and storage of raw materials or finished products and managing the risks associated thereto.
- [Managing inventories](#) – Includes considering minimum acceptable inventory levels, managing the frequency of stock take, whether using storage space effectively, perishability of inventory and ensuring security procedures are in place.
- [Taking orders](#) – Related to the provision of the order processing element of the entire fulfilment process, whether that is manual or electronic.

For a service center business:

- [Providing consulting or other administrative services](#) – Encompasses the provision of any type of service to the Licensee’s FCGs.

KPMG observations



It is yet to be seen whether the RAG will prevail over the Regulations. Whilst the RAG has shed light on various issues surrounding the applicability of the Regulations, we have observed several inconsistencies of the RAG with the Regulations which undoubtedly impacts Licensees operating in unique sectors or business models.

For instance, the Regulations state that one of the conditions for a Licensee to be considered as carrying on a 'distribution business' is that the goods must be 'imported and stored in the UAE'. However, this condition is not explicitly mentioned in the RAG. Therefore, UAE entities that adopt the 'drop shipment model' should assess whether it falls within the definition of a 'distribution business' and ascertain the need to demonstrate economic substance in the UAE.

As the RAG stipulates that Licensees should consider the substance of the transaction/activity (rather than its legal form) in determining the applicability of the Regulations, a question arises as to whether UAE mainland entities which hold equity investments in another entity(ies) and does not exercise control but reaps all the economic benefits from such investments, would be considered as a 'holding company business'.

Another interesting perspective is with respect to group entities, where an employee sits in the UAE and functions as Head of Tax/Finance/HR/IT for the group. As this is a very common scenario in the UAE, being a regional trading and entrepreneurship hub, would all UAE entities having this structure be classified as undertaking a 'headquarters business'?

The RAG has also provided a very broad definition of what 'gross income' is in the context of the Regulations. Taking into consideration the definition set out in the RAG, UAE entities which are recharging costs (say employee expenses) in relation to services provided to its FCGs and sets off the amount received from the FCGs entirely against such costs in its income statement, may still be viewed as earning gross income from a relevant activity.

From a practical perspective, Licensees situated in the mainland UAE, which are carrying out a 'lease-finance business' but are not registered with the UAE Central Bank would need to obtain clarity as to the specific regulatory authority where such UAE Licensees would be required to submit the notification and report.

As the Regulations are still in a nascent stage, application could be challenging for UAE entities – especially for those that operate more complex business models.

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