



# A matter of substance

The global tax environment that banks operate in is evolving as a result of the implementation of the Base Erosion and Profit Shifting (BEPS) initiative. In 2019, the UAE introduced a legal requirement for entities that perform certain “relevant activities” to locally maintain adequate economic substance. David Fernley simplifies its intricacies.

Global corporate tax reform is being driven by the G20 countries and the Organization for Economic Co-operation and Development (OECD). Due to BEPS and the creation of a European Union (EU) list of non-cooperative tax jurisdictions (“blacklist”) many low tax jurisdictions have implemented economic substance requirements. Economic substance can broadly be considered to consist of employees, premises, management and costs.

The UAE economic substance regulations were enacted on 30 April 2019, and the UAE was subsequently removed from the EU blacklist as a result. This is positive news for banks as the blacklist status was causing general concerns for foreign counterparties interacting with UAE banks. It does, however, introduce further tax compliance requirements for banks across their UAE legal entity structure and operations.

## Defining relevant activities

The regulations introduce a legal requirement for UAE entities that perform certain “relevant activities” to locally maintain adequate economic substance, in line with the level and type of activity they undertake. The law also requires that the entity must undertake its key business activities in relation to relevant activities “core income generating activities” (CIGA) in the UAE.

There are also various regulatory filing requirements that need to be met in order to comply with the regulations, and there are financial fines and penalties (revocation of license and/or information exchange with foreign governments) in case of non-compliance.

“Relevant activities” consist of any of the following businesses licensed in the UAE, (mainland and/or free trade zones):

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

Companies that have at least 51% direct or indirect UAE government ownership are currently out of the scope of the regulations.



## Key takeaways for UAE banks

- Whilst UAE banks generally have significant UAE substance, the devil is in the detail with regard to meeting the economic substance requirements. Substance needs to be considered per the UAE entity or branch, and per relevant activity
- UAE banks are required to perform an economic substance impact assessment and gap analysis across their legal entity structure and remediate accordingly
- The substance regulations also apply to UAE branches of foreign banks
- Similar substance rules have also been enacted in commonly used legal entity jurisdictions such as Bermuda, the British Virgin Islands, the Cayman Islands, Isle of Man, Guernsey and Jersey

- “Substance” is often referred to in a number of tax contexts depending upon the tax issue at hand. For example, an entity that meets the UAE economic substance test does not automatically qualify to receive a UAE tax residence certificate; nor does it automatically qualify for double tax treaty relief in a foreign market
- Banks that apply a group transfer pricing policy will be better placed to justify compliance with the economic substance rules.

## Maturing regulatory regimes

As a result of the global focus on tax evasion, UAE banks and banks globally have been required to comply with the US Foreign Account Tax Compliance Act (FATCA) and the OECD’s Common Reporting Standard (CRS) for a number of years. These are often referred to as “automatic exchange of information”

(AEOI) or “customer tax transparency” regimes. These regimes broadly require banks to identify and record the tax residence of their account holders and report this annually to their local authority. The local authority then shares this information with tax authorities globally, as relevant.

UAE banks invested resources in implementing compliance frameworks for these regimes between 2014 and 2017. Since implementation, global interpretations and practices have had time to evolve and tax authorities in various countries have begun audit and enquiry activity in to local banks’ AEOI compliance. There is an expectation from the OECD that tax authorities in all countries proactively monitor compliance of local banks in this manner and enforce the requirements robustly. Governments will be peer-reviewed on this.





## AEOI: what should UAE banks do now?

Against this backdrop many banks globally are performing AEOI health check exercises, bearing in mind the following considerations:

- Test of design: Is the existing AEOI compliance and governance framework fit for purpose in today's environment?
- Test of effectiveness including sample testing and data analytics: Has the bank's compliance programme been effective since implementation? Is remediation required?
- Is the bank's end-to-end AEOI technology framework fit for purpose?
- How does the bank get assurance on the ongoing effectiveness of the AEOI programme, e.g. through periodic healthchecks, reporting?

- How does AEOI impact the customer experience through the Know Your Customer(KYC)/ anti-money laundering (AML) process and beyond? Can this be improved or optimized given developing practice in the market?
- Training: do customer-facing and compliance staff have the correct, up to date training?

AEOI may expose banks to financial risks in relation to fines, penalties and the cost of compliance. There are also significant reputational risks. The customer data that is reported is extremely sensitive in nature—essentially the customer's personal data and financial data on their account balances and movements. Aside from the obvious data protection concerns, any inaccuracy could result in a bank's customer receiving tax audits or enquiries from

foreign tax authorities. The diligence required to be performed by the bank also impacts the customer onboarding journey. Therefore, banks that are yet to carry out health checks would be well advised to conduct rigorous internal reviews to ensure compliance with all relevant regulations, or risk serious pecuniary, legal, and reputational damages.

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