The Future of Economic Substance Regulations in the United Arab Emirates

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As part of the OECD, and in response to an assessment of the United Arab Emirates' ("UAE") tax framework by the European Union Code of Conduct Group on Business Taxation, the UAE issued the Economic Substance Regulations in April 2019, hereinafter "ESR" (Cabinet of Ministers Resolution No. 31 of 2019), later amended in August 2020 (Cabinet of Ministers Resolution No. (57) of 2020). In January 2022, the UAE's Ministry of Finance announced the introduction of a Corporate Income Tax ("CIT"). This article discusses the future of the ESR in light of the announced introduction of the CIT in the UAE.

1. What has happened so far?

a. Economic Substance Regulations

The Economic Substance Regulations (ESR) were issued in 2019 and amended in 2020 to essentially reach two targets:

- to fulfil its obligations under the OECD's measures to prevent base erosion and profit shifting ("BEPS"); and
- to delist the UAE from the EU's list of non-cooperative jurisdictions for tax purposes.

Both targets were achieved on 10 October 2019, when the UAE got delisted.

b. Corporate Income Tax

On 31 January 2022, the UAE's Ministry of Finance ("**MOF**") announced that the UAE would introduce a corporate income tax ("**CIT**").

The CIT will be applicable for financial years starting on or after 1 June 2023 onwards. If the financial year ends on 31 December, businesses will be subject to CIT starting from 1 January 2024.

The MOF has announced the following CIT rates:

- 0% for taxable income not exceeding AED 375,000; and
- 9% (standard rate) for taxable income exceeding AED 375,000.

However, a different tax rate will apply for Multinational Entities ("**MNE**") that fall within the scope of 'Pillar Two' of the OECD Base Erosion and Profit Shifting (BEPS) project (specifically, MNE groups that have consolidated global revenues exceeding EUR 750 Mio. (approx. AED 3.15bn)).

Furthermore, businesses established within free zones can benefit from a 0% CIT rate provided that

- they comply with all regulatory requirements; and
- they do not conduct business with mainland UAE.

Since the CIT law has not yet been enacted, numerous aspects remain unclear, one of them being the future of ESR.

2. What does the future of the ESR look like?

The introduction of CIT in the UAE raises the question of how the UAE will deal with ESR in the future. The MOF has neither addressed this when it first announced the introduction of CIT in January 2022 nor made any direct statement in this regard in its public consultation document ("**PCD**") which was issued in April 2022.

Regardless of this, there are three options for the ESR's future:

- Full retention;
- Complete abolition; or
- Partial abolition.

a. Full retention of ESR

Under this option, both CIT regulations and ESR would exist in parallel. Potentially, the ESR would be incorporated into the CIT regulations.

b. Complete abolition of ESR

Under this option, the ESR would be abolished, and businesses would not need to comply with the previous requirements (Relevant Activity Assessment, Economic Substance Notification, Economic Report, etc.).

c. Partial abolition of ESR

Under this option, the ESR would only be partially abolished. It is conceivable that the ESR's scope would be particularly reduced to free zone companies benefiting from the 0% CIT rate.

d. Evaluation – the Qatar model?

Based on the ESR's strategic goal to prevent harmful profit shifting, the ESR's complete abolition is not a viable option. This is based on the notion that the UAE's CIT regime will allow favourable tax arrangements through its free zones.

While not all conditions for the favourable tax treatment of free zone corporate vehicles are fully disclosed at the time of writing (since the CIT law has not yet been published), a supporting argument can be derived from the PCD. According to item 3.27, one of the prerequisites for benefiting from the 0% CIT rate will be to "maintain adequate substance".[1]

A glance "across the border" supports this view. Qatar recently issued ESR (Decision No. 20 of 2021). Although Qatar imposes a CIT (10% standard rate), ESR requirements are relevant for businesses that benefit from favourable tax arrangements. Corporate vehicles in free zones and economic zones whose income is not subject to CIT are required to comply with the new ESR requirements.

Based on the above, it is expected that the ESR will stay relevant at least for

[1] Whilst companies and branches that are registered in a Free Zone (hereafter referred to as "Free Zone Persons") will be within the scope of the UAE CT and subject to tax return filing requirements, the UAE CT regime will honour the tax incentives currently being offered to Free Zone Persons that maintain adequate substance and comply with all regulatory requirements.

free zone corporate vehicles in the UAE that benefit from preferential CIT treatment (0%).

3. Conclusion

The much-awaited CIT legislation will certainly add complexity to the UAE's regulatory landscape. What role the ESR will play within the UAE's tax framework remains to be seen. In our view, ESR will continue to apply at least to free zone corporate vehicles benefitting from the 0% CIT rate.

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