

# Economic Substance Laws

## Applicability & Requirements

ALGERIA  
ETHIOPIA  
GUINEA  
KENYA  
MADAGASCAR  
MALAWI  
MAURITIUS  
MOROCCO  
MOZAMBIQUE  
NIGERIA  
RWANDA  
SUDAN  
TANZANIA  
UGANDA  
ZAMBIA  
• • •  
UAE



# Background

Base Erosion and Profit Shifting (BEPS) is the use of legal tax planning strategies by companies to artificially shift profits to low or no-tax jurisdictions (in which there is little or no economic activity being undertaken by those companies). BEPS is a major concern for governments across the world and new BEPS laws and regulations are now enacted in most if not all “offshore” jurisdictions. Therefore, if you own or control an offshore company, you need to carefully consider how BEPS might impact how you do business.

In order to address BEPS in a comprehensive manner, the Organisation for Economic Co-operation and Development (OECD) together with the G20 established an Inclusive Framework on Base Erosion and Profit Shifting (BEPS Framework). There are currently more than 125 jurisdictions which have agreed to collaborate on the implementation of the BEPS Framework. Critically, many of the traditional offshore jurisdictions like BVI, Cayman Islands, Jersey, Mauritius and the United Arab Emirates have passed laws to implement the BEPS Framework in some form in their respective jurisdictions.



## Actions under the BEPS Framework

The BEPS Framework provides 15 actions (out of which 4 have been identified as the minimum standard that all member jurisdictions of the BEPS Framework must commit to implementing), which equip governments with the tools (both domestic and international) to tackle BEPS. One of the minimum standard actions is Action 5 (harmful tax practices), which focuses on improving transparency and on requiring substantial activity for a jurisdiction that has low or no tax regimes.

One of the key principles behind the BEPS Framework is that a jurisdiction should not facilitate offshore structures and arrangements aimed at attracting profits that do not reflect the real economic activity in that jurisdiction.

## Economic Substance Requirements

In order to comply with Action 5 of the BEPS Framework, a number of the 'no or only nominal tax' jurisdictions identified above have implemented economic substance laws and regulations (EC Laws) whereby certain reporting and economic substance requirements have to be satisfied by entities undertaking activities in those jurisdictions. The EC Laws in these jurisdictions are by and large similar.

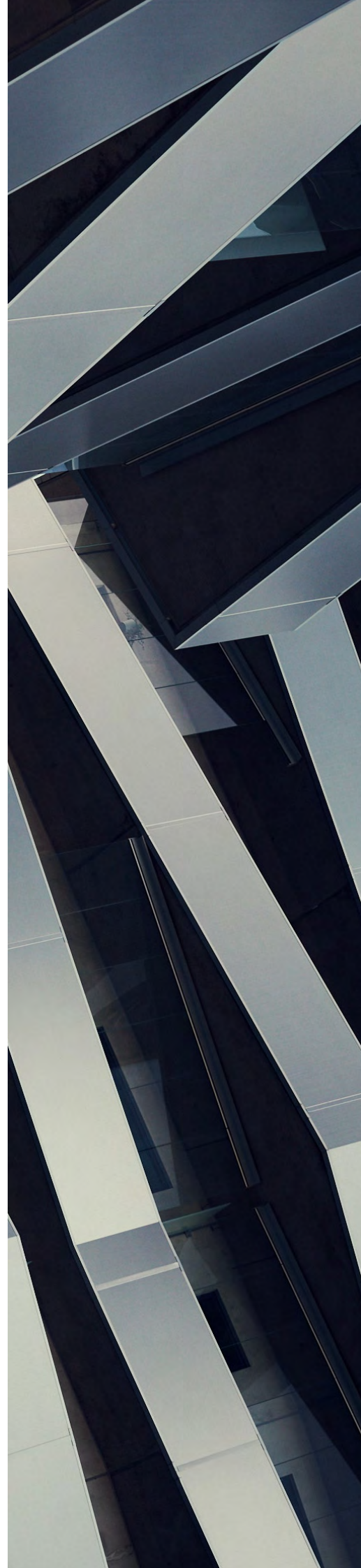
## Are the EC Laws applicable to your entity?

In general terms, the EC Laws apply only to "relevant entities" that undertake any of the "relevant activities". Where a relevant entity undertakes more than one relevant activity, it would be required to comply with the EC Laws in respect of each relevant activity it undertakes. In order to determine whether the EC Laws are applicable to your entity, the following critical analysis must be undertaken:

### Relevant Entity Analysis

The first step is to analyse whether your entity will be considered as a "relevant entity" under the applicable EC Laws. Typically, all legal entities established in any of the above jurisdictions are considered to be relevant entities and are thus required to comply with the EC Laws. However, there are some important exclusions.

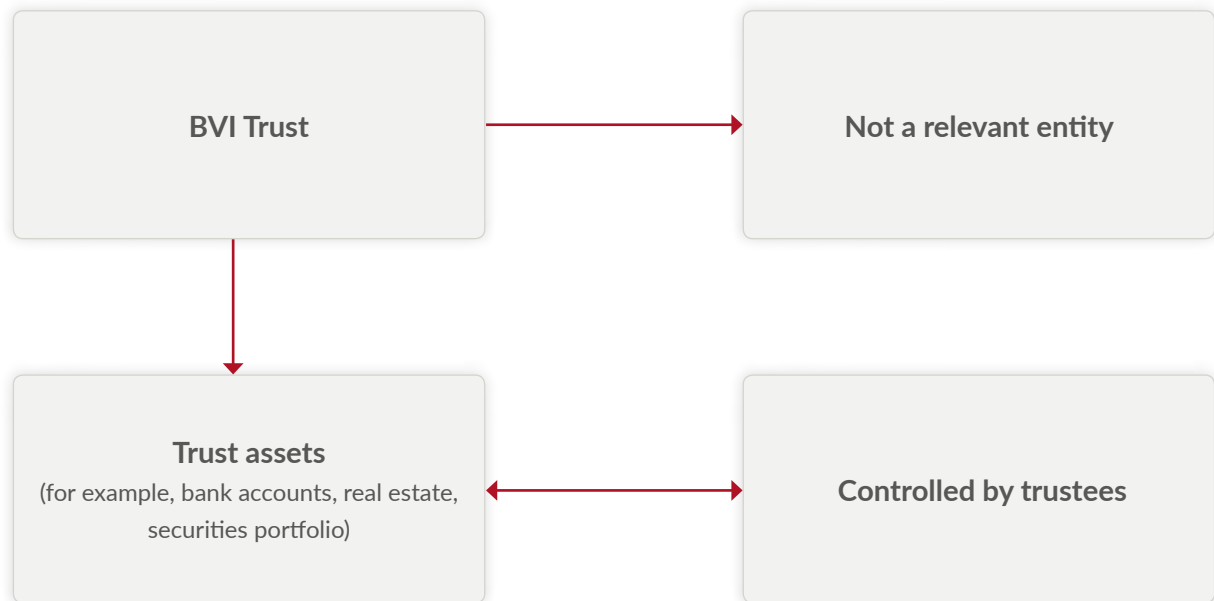
For instance, in Cayman Islands, investment funds and exempted limited partnerships have been excluded whereas in the UAE, only companies that are wholly or partially owned by the government have been excluded. Additionally, it is also important to point out that an unincorporated trust does not fall under the EC Laws because a trust is not a legal entity.



Accordingly, if trust assets are held directly by the trustees of a trust (see Example 1 below), then the EC Laws would not apply. However, it is the case that most trustees will not hold trust assets directly but rather by means of owning an offshore company that will own the trust assets (see Example 2 below). In this case, an offshore company owned by trustees would be a relevant entity under EC Laws. Accordingly, trustees and settlors of trusts should consider their position if trust assets are held through an offshore company.

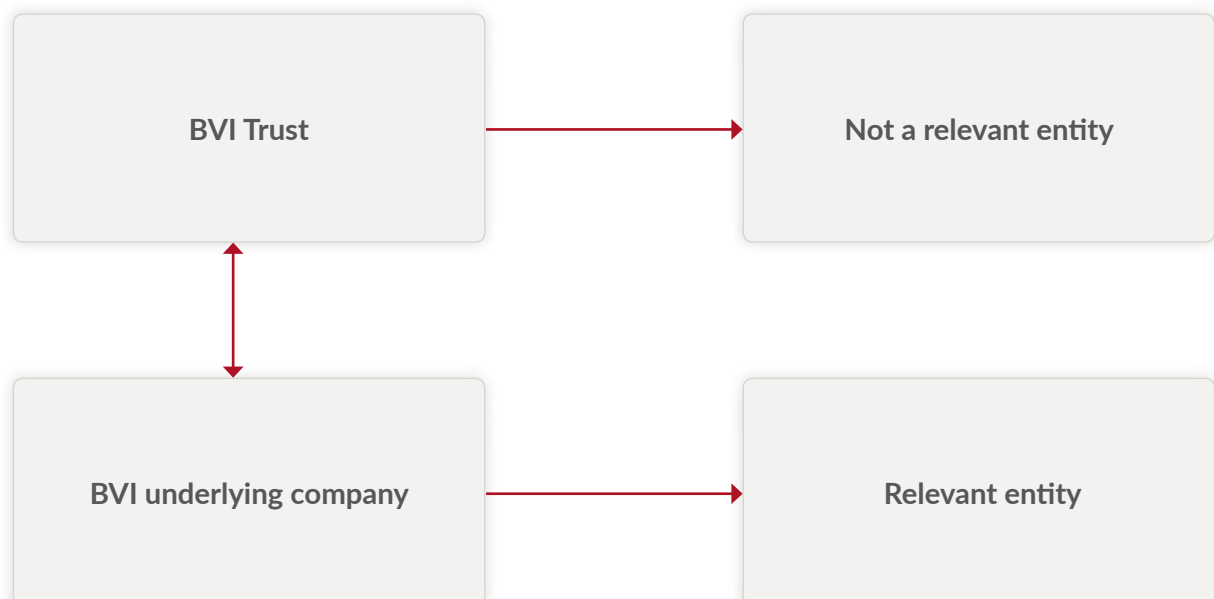
#### EXAMPLE 1: Trust assets held directly by the trustees

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#### EXAMPLE 2: Trust assets held through an offshore company

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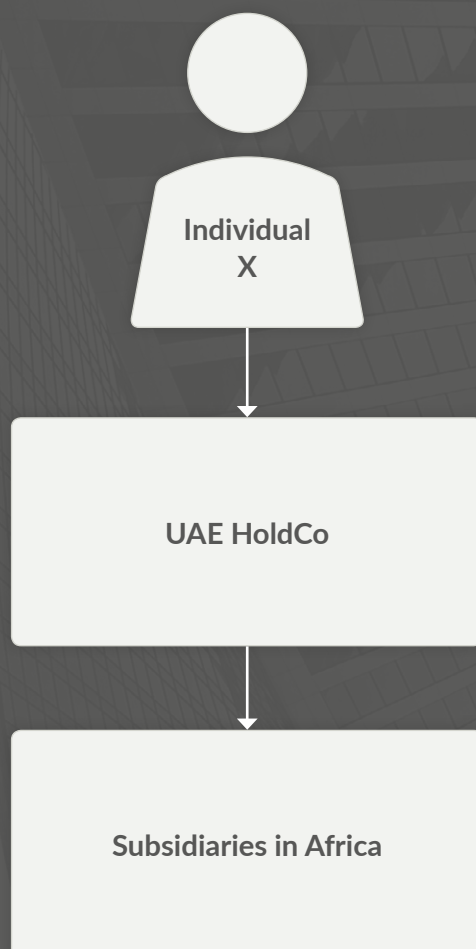


## Relevant Activity Analysis


If your entity is considered to be a relevant entity, in that it is not specifically exempted, then the next step is to determine whether your entity undertakes one or more of the activities that have been identified as “relevant activities”. The EC Laws have identified the following nine categories of activities as being relevant activities:

1. Banking business
2. Distribution and service centre business
3. Insurance business
4. Shipping business
5. Fund management business
6. Holding company business
7. Finance and leasing business
8. Intellectual property business
9. Headquarters business

We expect that, for a majority of business owners, the “Headquarters business” and “Holding company business” categories will have the most relevance. Diagram 1 below will assist in understanding the analysis better:







Under this structure, individual X established a UAE Holding Company (**UAE HoldCo**) in a free zone in the UAE, which in turn wholly owns various subsidiaries in different African countries. In order to determine whether the UAE EC Laws apply to the UAE HoldCo, the two tests described above must be applied.

- i. **“Relevant Entity” Analysis** – UAE HoldCo satisfies the relevant entity test as it is a legal entity established in the UAE and is not partially or wholly owned by the government. Therefore, UAE HoldCo is not exempted.
- ii. **“Relevant Activity” Analysis** – it is then necessary to determine whether UAE HoldCo undertakes any of the relevant activities. In this case, it is acting as a pure holding company and does not undertake any trade or business in the UAE; the requirements under UAE EC Laws relating to holding companies would prima facie need to be satisfied by UAE HoldCo.

Assuming that UAE HoldCo also provides services (such as management services) or purchases any goods or products from any (or all) of its subsidiaries in Africa and resells them, then the UAE HoldCo would be engaging in two relevant activities: (i) holding company activity and (ii) the distribution and service centre business. UAE HoldCo would, accordingly, be required to comply with the requirements under EC Laws for both activities.

## What action must be taken to satisfy the requirements under EC Laws?

The requirements under EC Laws that are to be satisfied depend on the relevant activity that is being undertaken. They can be broadly divided into three different categories as follows:

- A. **Standard Requirements:** The standard requirements are applicable in relation to all relevant entities, excluding holding companies and high-risk intellectual property entities (the requirements for these entities are set out below), which are carrying out a relevant activity and generating revenue income from such activities. If a relevant entity does not carry on any relevant activity or does not generate any revenue income from such activities, then it is only required to comply with certain basic filing requirements and does not have to satisfy the substance requirements. For example, if a company is incorporated in the UAE to allow the company’s shareholder to obtain a residence visa, then such a company would not need to satisfy the substance requirements.

A relevant entity, which falls under the purview of the standard requirements, is required to demonstrate that it:

- i. conducts core income-generating activities. These are activities which are of central importance to a relevant entity in terms of generating relevant income and, if carried on by a relevant entity, must be carried on in the relevant jurisdiction. The core income generating activities vary depending on the relevant activity. For example, in relation to the “distribution and service centre business”, core income generating activities would include managing stocks, taking orders, transporting and storing goods, providing consulting or other administrative services. If the entity is established in the UAE, then the “distribution and service centre business” must be carried on from the UAE.

It should be noted that, in certain circumstances, the core income-generating activities may be outsourced to a corporate service provider/agent in the relevant jurisdiction. In such cases, the relevant resources of the service providers would be taken into account when determining whether the core income generating activities test has been satisfied

- ii. is directed and managed in the relevant jurisdiction with regards to the relevant activity. Some of the ways to demonstrate that the entity is directed and managed in the relevant jurisdiction is by: (a) having majority of the board meetings in the relevant jurisdiction; (b) adequate number of meetings held, given the level of decision-making; (c) quorum of the board to be physically present in the relevant jurisdiction; (d) all company records being kept in the relevant jurisdiction; (e) the directors having the necessary knowledge and expertise to discharge their duties as directors; and (f) meeting minutes being kept in the relevant jurisdiction; and
- iii. has an adequate amount of operating expenditure, physical assets, physical presence and full-time employees with appropriate qualifications in the relevant jurisdiction.

- B. Holding Company Requirements:** Currently, under the EC Laws, ‘pure equity’ holding companies are subject to a reduced substance regime which only requires such companies to: (i) comply with its statutory obligations; and (ii) have adequate employees and premises to carry out the activities of a holding company. If the relevant entity is a passive holding company, then these requirements may also be satisfied by the relevant entity’s registered service provider. For example, an offshore company incorporated with the Jebel Ali Free Zone Authority and acting as a passive holding company would satisfy the substance requirements by retaining the services of a registered agent.

It should be noted that a holding company that derives income from one of the other relevant activities would not be able to benefit from the reduced substance regime applicable to a ‘pure equity’ holding company and would be required to comply with the more stringent economic substance requirements relating to the relevant activity that is generating the additional income. For instance, if a holding company also distributes any goods or products for its subsidiaries then it would be required to comply with the more stringent substance requirements (as set out in paragraph A above) relating to companies engaging in distribution and service centre business.

- C. High Risk Intellectual Property (IP) Entity Requirements:** An entity is considered to be a high risk IP entity if it carries on IP business and has: (i) acquired the IP asset from an affiliate or as consideration for funding research and development by another person situated in a jurisdiction other than the relevant jurisdiction; and (ii) licenses the IP asset to one or more affiliates or otherwise generates income from the asset as a result of activities performed by foreign affiliates.

The requirements under EC Laws for a high-risk IP entity are more rigorous than those for other entities and may include (in addition to the requirements set out in paragraph A above) (a) provision of a detailed business plan laying out the commercial rationale for holding the IP assets in the relevant jurisdiction; (b) information on employees in the relevant jurisdiction (including experience, contractual terms and qualifications); (c) annual reporting obligations irrespective of whether any income has been generated from undertaking the relevant activity.

## Failure to comply with EC Laws

Failure by an entity to satisfy its obligations under EC Laws may result in financial penalties being levied against that entity, its directors and managers. Additionally, constant failures by an entity may also result in the relevant entity being struck off by the registrar of companies in the relevant jurisdiction.

Critically, where the relevant entity fails to meet the substance requirements for any financial year, the tax (or other competent) authority in the country of incorporation of the relevant entity (whether Cayman, BVI, Jersey or UAE) is, pursuant to international treaties that the country has in place, required to provide the information relating to the non-compliance by the relevant entity to the foreign tax (or other competent) authorities where the parent company, ultimate parent company and ultimate beneficial owner resides. Based on such information, the foreign tax (or other competent) authorities where the parent company, ultimate parent company and ultimate beneficial owner resides could potentially claim that the relevant entity (whether incorporated in Cayman, BVI, Jersey or UAE) is resident for tax purposes in the country of residence of its parent company, ultimate parent company or its ultimate beneficial owner, which in turn may result in tax liabilities for the parent company, ultimate parent company or its ultimate beneficial owner.

For example, if a UAE company undertaking distribution and service centre business on behalf of its subsidiaries in Africa is unable to satisfy the substance requirements in the UAE, then the income earned by the UAE company may be construed by the tax authorities in the relevant African jurisdictions to be the income of the relevant subsidiary in that African jurisdiction and subject to taxation in the relevant African jurisdiction.

## Time period

The standard time period within which a competent authority in the applicable jurisdictions may make a determination as to whether a relevant entity has to comply with the EC Laws is six years after the end of the relevant financial year in connection with which the determination is being made. This time bar period does not apply if the competent authority is not able to make the determination by reason of any deliberate misrepresentation or negligent or fraudulent action by the relevant entity or by any other person.

## Conclusion

The EC Laws are still evolving and are subject to regular amendments and updated guidance from the relevant authorities in each jurisdiction. In most jurisdictions, the EC Laws came into force in 2019 and as such, competent authorities will be required to make a determination as to whether relevant entities incorporated in their jurisdiction satisfied the substance requirements in 2019. Therefore, as an initial step, it is important for organisations and individuals having a corporate entity in one or more of the popular 'no or only nominal tax' jurisdictions (like, BVI, Cayman, Jersey and UAE) to obtain appropriate advice and make a determination whether in the jurisdiction of incorporation, their corporate entity: (i) would be classified as a relevant entity; (ii) does or intends to undertake a relevant activity. If the corporate entity is classified as a relevant entity and is undertaking a relevant activity, then it is critical that the relevant entity understands and complies with the applicable requirements under the EC Laws as soon as reasonably practicable.



## Key contacts

Should you require more information, please do not hesitate to contact:



**Atiq S. Anjarwalla**

Managing Partner  
Anjarwalla Collins &  
Haidermota

[aanjarwalla@ach-legal.com](mailto:aanjarwalla@ach-legal.com)



**Daniel Ngumy**

Partner  
ALN Kenya | Anjarwalla &  
Khanna

[dng@africalegalnetwork.com](mailto:dng@africalegalnetwork.com)



**Kenneth Njuguna**

Senior Associate  
ALN Kenya | Anjarwalla &  
Khanna

[kkn@africalegalnetwork.com](mailto:kkn@africalegalnetwork.com)



**Devvrat Periwal**

Principal Associate  
Anjarwalla Collins &  
Haidermota

[dperiwal@ach-legal.com](mailto:dperiwal@ach-legal.com)



**Edward Macharia**

Associate  
Anjarwalla Collins &  
Haidermota

[emacharia@ach-legal.com](mailto:emacharia@ach-legal.com)