

# Bahrain | Economic substance rules: A year later

October 2020

## Background

The Ministry of Industry, Commerce and Tourism (MoICT) and the Central Bank of Bahrain (CBB) issued a Directive OG/499/2018 (CBB Directive) on 22 November 2018 and a Ministerial Decision no. 106 (MO 106) on 27 December 2018 (collectively 'Economic Substance Rules' or 'ESR') imposing substance requirements for Bahraini entities undertaking geographically mobile activities in, from or through Bahrain. We have set out below some of the key developments that took place within the first year of implementation as well as key practical compliance issues, and what stakeholders can potentially expect going forward.

### Introduction

The ES rules apply to entities (corporations, branches and partnerships) that are carrying on one or more of the following relevant activities:

- Distribution and service centre
- Headquarters
- Holding company
- Leasing
- Shipping
- Intellectual property (IP)
- Banks
- Financing companies
- Insurance
- Investment firms (CBB categories 1 & 2)
- Fund administrators

Some of the above activities are regulated by the CBB and therefore need to report to the CBB.

Entities undertaking one or more of the relevant activities must meet the Economic Substance (ES) tests – prove that have genuine commercial operations and management in Bahrain – and lodge the ES Return within 3 months from the financial year end to the relevant competent authority.

### Extension of time

On 29 March 2020, the MoICT (due to Covid-19) extended the reporting deadline of 31 March 2020 by 3 months to 30 June 2020. For CBB regulated, extension of time was only granted by the CBB on a case by case basis.

We do not expect a similar concession to be given for subsequent financial years on the basis that no extension of time has been granted for entities with financial years ending after 31 December 2019. Therefore, we urge impacted entities to be well prepared for a timely filing.

### Substance over form

On 3 June 2020, the MoICT issued a list of commercial registration (CR) activity codes which the MoICT considered to be relevant activities under the ES rules. It appears that MoICT only requires entities whose activities are mentioned in this list to comply with the ESR.

This has created confusion among entities as to whether a "substance over form" approach should be adopted. In the UAE for example, a licensee must look beyond what is stated in the commercial license to the activities **actually** undertaken by the licensee during a financial period in order to determine the applicability of the ESR.

In practice, we have seen some entities in Bahrain that have not updated their CRs since their inception having to comply even though they are not actually carrying out a relevant activity. In contrast, entities which are carrying out a relevant activity but their CR activity code is not in the MoICT list are not having to file an ES return.

Ultimately, all these entities will need to carefully consider the activity codes listed under their CR and the actual activity they are undertaking and amend their CRs.

In our view, the entity needs to review the actual activities they are undertaking and assess (regardless of what their CR states) whether they are carrying out a relevant activity and therefore comply with the ESR.

### Violations for non-submission of ES return

Since July 2020, the MoICT have been issuing violations against entities that had failed to submit their ES Returns by the mandated deadline. Consequently, these entities were not able to

renew their CRs until the violation was corrected. We understand that this was not based on an assessment or audit by the MoICT as to whether entities were meeting the ES rules but it was done to ensure those entities with a CR activity codes falling within a relevant activity under the ESR filed their ES returns. We expect the MoICT to review ES return filings in due course to assess those entities that may not be complying with the substance requirements.

We recommend all impacted entities file their ES returns urgently as delays may not only result in an inability to renew CRs but the imposition of more onerous penalties.

### Covid-19

The MoICT recognizing that Covid-19 will have an impact on the way many companies operate issued, a guidance note on 25 June 2020 addressing concerns around compliance with the ES rules:

- When assessing compliance with the ES rules, the MoICT will take into account circumstances that may have caused issues with compliance due to Covid-19 (such as travel restrictions, self-isolation or quarantine requirements).
- In terms of the direction and management test, the MoICT have clarified as follows:
  - Not all directors have to attend board meetings in Bahrain – only quorum required.
  - Companies should consider the use of alternate directors in Bahrain who can attend meetings.
  - Only meetings in relation to “Core Income Generating Activities” (CIGAs) need to be held in Bahrain.
  - Meeting may be held virtually but normal meeting protocols should be observed.
- Requirement to directed and managed in Bahrain is only one element and the requirement to conduct CIGAs in Bahrain is a must.
- Businesses may be asked to provide evidence as to how their operating practices have been affected due to Covid-19.

The guidance is temporary and entities are urged to make every effort to otherwise comply with the

full substance requirements (including filing deadlines) as the practical and temporary approach described in the guidance note only applies to entities that need to make adjustments to their usual operating practices so far as these are necessary to manage the threats arising from the Covid-19 outbreak.

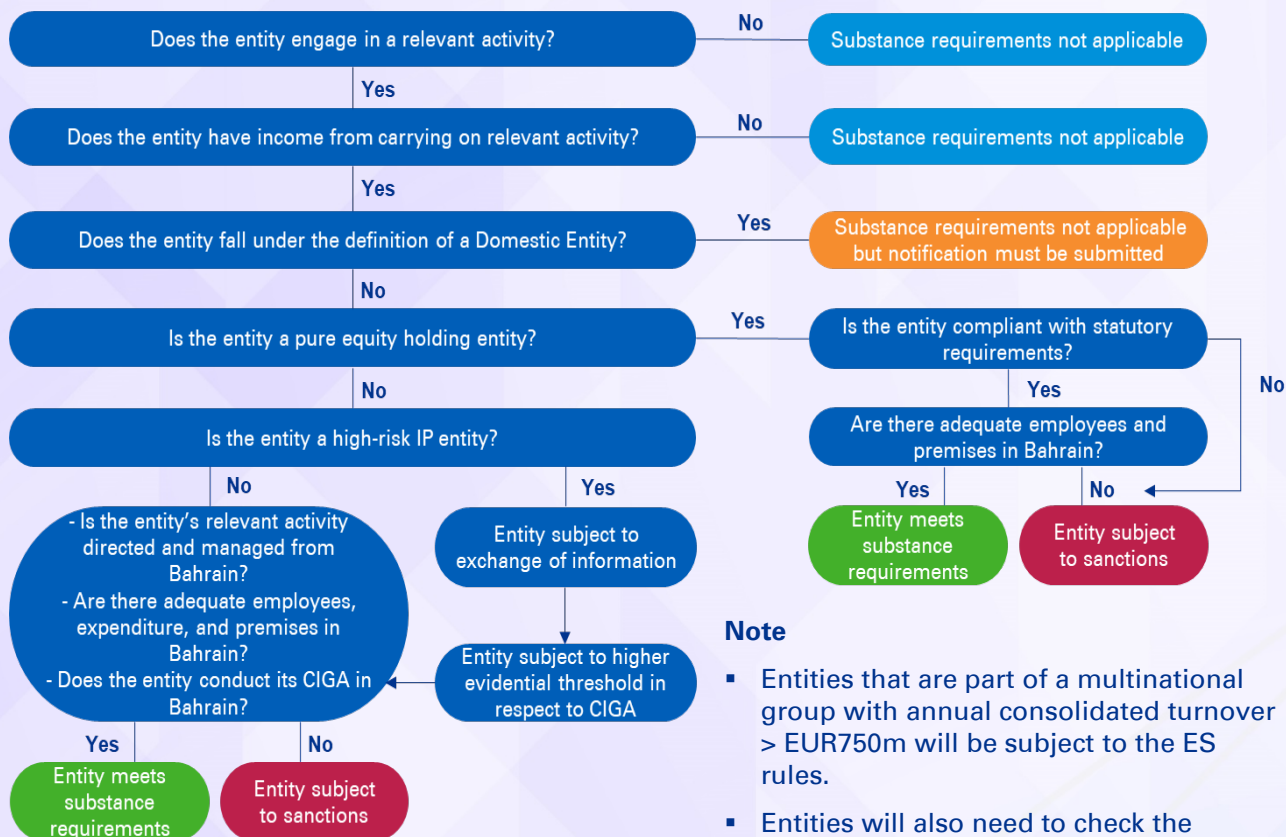
Detailed records should be kept of all Covid-19 circumstances that may have impacted compliance with the ESR, including travel restrictions, the dates of such restrictions and the reasons for them.

### Going forward

- While there has been no indication by the CBB that it will adopt an online filing mechanism for the ES reporting, we expect the MoICT to set up the online filing system via Sijilat soon.
- Entities carrying out a relevant activity must ensure that their CIGAs in Bahrain are carried out with an adequate amount of annual expenditure, adequate qualified Bahrain resident resources and adequate physical offices. There is currently no guidance on what is adequate from the competent authority.
- Entities should undertake a gap analysis and develop an action plan to meet the substance requirements. A benchmarking analysis may be required on the adequacy test.
- Where possible, consider outsourcing your CIGAs and ensure the entity is directed and managed from Bahrain.
- Was the ES return based on the MoICT (relevant) activity list? If there is a conflict between the (relevant) activity undertaken by the entity and the activity listed on the CR, the entity will need to amend its CR.
- In the UAE, the Federal Tax Authority (FTA) has now been appointed as the authority to assess whether licensees have met the economic substance tests and impose administrative penalties for non-compliance. Penalties have increased substantially. Is Bahrain likely to do the same?
- An assessment or audit by the MoICT is inevitable.



## ESR Decision Tree



### Note

- Entities that are part of a multinational group with annual consolidated turnover > EUR750m will be subject to the ES rules.
- Entities will also need to check the activity code on the CR against the MoICT list as this may trigger a filing requirement.

This is for general information only and is not intended to address the circumstances of any particular scenario. Please seek professional advice in relation to your particular circumstances.

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