Tax alert | Economic substance rules for Bahrain

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In Resolution 106 of 2018 and in additional guidance issued in January 2020, the Ministry of Industry, Commerce and Tourism (MOICT) sets out how businesses registered in Bahrain must 'validate their economic substance'. In essence, Bahrain-registered businesses must prove that they have genuine commercial operations and management in the country, rather than establishing a presence here simply for tax reasons. The CBB has issued a similar directive (OG/499/2018) to all of its licensees.

As a lower-tax jurisdiction, Bahrain has successfully attracted many regional and international businesses, helping to further diversify the economy. However, there are concerns that businesses may have tried to take advantage of lower taxes by shifting profits here rather than being taxed where economic value was actually created. Economic substance rules across the GCC are a response to increasing scrutiny – by tax authorities in other jurisdictions, global bodies such as the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU) as well as the general public - of attempts by businesses to unfairly benefit from beneficial tax regimes.

Which businesses do the economic substance rules (ESRs) apply to?

Broadly, businesses in Bahrain with activities connected with:

- Banking and insurance
- Fund management
- Investments
- Financing and leasing
- Distribution and service centres
- Headquarters
- Holding companies
- Leasing (other than those undertaken by CBB licensees)
- Shipping
- Intellectual property

How can entities show they meet the ESRs?

The ESRs define sector-specific core income generating activities (CIGAs) that must be conducted in Bahrain. Companies are required to submit a report to the relevant regulator which indicates:

- CIGAs are conducted, directed and managed in Bahrain
- Management and shareholder meetings are held in Bahrain
- Strategic decisions are made by people in Bahrain with appropriate[1] experience
- All appropriate[1] records – including accounting books – are maintained in Bahrain - (external service providers must be named) with appropriate[1] oversight
- Physical assets and sufficient full-time employees with adequate[1] experience are based in Bahrain
- Operating expenditures in Bahrain are appropriate[1] to undertaken activities
- Internal policies and controls have been established to monitor ESR compliance

[1] MOICT guidelines clarify that *adequate* and *appropriate* mean what is considered proportional to the level of activity undertaken

Penalties and sanctions

If companies fail to meet the ESRs, MOICT will inform the competent authority where the ultimate parent or beneficial owner is established of their non-compliance, which may lead to the denial of treaty benefits. In addition, MOICT – or, for regulated financial institutions, the CBB - can suspend, revoke or deny renewal of a CR or licence as well as levying significant fines (up to BD100,000) and possible imprisonment.

Automatic exchanges of information (EoIs)

MOICT and CBB are required to report compliance with the ESRs to the Bahrain Competent Authority (BCA) within 90 days. Within 30 days of receiving a report, the BCA is required to assess whether the information should be exchanged with authorities in the jurisdiction of the ultimate parent or beneficial owner in accordance with the OECD's EoI manual.

When does the order come into effect?

For businesses regulated by MOICT, the order is effective 1 July 2019 for existing businesses and 1 January 2019 for businesses applying for new CRs or new activities on existing CRs. For CBB licensees, the directive came into effect on 1 January 2019 with a report due within three months of the end of the financial year. Businesses that fall under the ES rules must file an ES return with the relevant regulator within three months of the end of the financial year end (that is, 31 March 2020 for the financial year ended 31 December 2019).

Bahraini entities must obtain prior approval for changes in shareholdings, the appointment of directors or external auditors and the establishment of offices outside Bahrain.

Who should be concerned?

All businesses with a Bahraini CR should assess whether they comply with the ESRs. While most businesses should not be adversely impacted, businesses that have set up in Bahrain without moving operations, decision-making or employees will need to urgently consider their status. Any Bahraini business with overseas activities or that are part of an multi-national group or that have transactions with non-resident parties may be impacted by the ESRs.

What should you do now?

Key decision makers at Bahrain businesses must:

- Understand the economic substance requirements (ESRs)
- Comply with the ESRs
- Calculate and monitor existing levels of economic substance in Bahrain
- Take necessary corrective actions if non-compliant

How can Keypoint help?

As a leading professional services firm with business advisory, financial and regulatory compliance and tax functions, Keypoint has the knowledge and expertise that Bahrain businesses – both financial and non-financial - will need to demonstrate they meet the ESRs.

For more information on how the ESRs are going to impact your business, please contact us.

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