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The Economic Substance Test: directed and managed in the UAE

By Stuart Walker and Sulakshana Senanayake | 15 September 2022

The UAE introduced the Economic Substance Regulations in April 2019 (later amended by Cabinet Resolution 57 of 2020 (ESR) and Ministerial Decision 100 of 2020).

The relatively new regulations have imposed a number of reporting requirements for virtually all private companies in the UAE. Despite this relative infancy, the Ministry of Finance has already started issuing heavy fines for companies which are not compliant with the regulations.

In applying these fines, the Ministry of Finance will apply the Economic Substance Test set out in Article 6 of the ESR. In essence, a company must demonstrate that:

- (a) it conducts the necessary core income-generating activity within the UAE;
- (b) the relevant activity is directed and managed in the UAE; and
- (c) there is an adequate presence (employees, assets) within the UAE.

The regulations specifically require an entity to show that the relevant activity is “directed and managed” in the UAE. In order for a relevant activity to be “directed and managed” in the UAE, an adequate number of board meetings must be held and attended by directors in person in the UAE. The ESR does not specifically set out what would constitute an “adequate” number of board meetings for the purposes of the “directed and managed” limb. The only guidance provided is that what is adequate will depend on the relevant activity being carried on as well as the level of income earned by the company in question.

The Ministry of Finance has recently fined a company tens of thousands of dirhams for failing to meet the “*directed and managed*” test, apparently due to the lack of evidence of the company (a subsidiary of a larger group) holding substantial board meetings. It appears that “*cosmetic*” board meetings held in view of satisfying this test may not be sufficient to convince the Ministry of finance that a company was being directed and managed in the UAE.

The Authors



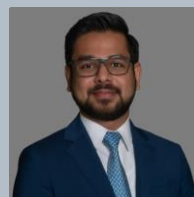
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Stuart's primary practice includes employment, financial services regulation, corporate finance and mergers and acquisitions. He leads the field in advising parties during Dubai Financial Services Authority (DFSA) investigations and was instructed by the first authorised firm to be fined by the DFSA. He has since gone on to advise in connection with a significant number of DFSA investigations. Stuart was admitted as a solicitor in England & Wales in 2001 and moved to Dubai in 2003.



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Sulakshana practices in the firm's dispute resolution group and advises and represents clients in litigation disputes. His experience and specialties include advising on and assisting with disputes relating to international law, commercial law, banking, labour law, fundamental rights and intellectual property. Sulakshana is a registered practitioner of the DIFC Courts with full rights of audience.

A subsequent appeal on the issue was also rejected. Penalties for subsequent failings can be hundreds of thousands of dirhams.

In order to avoid such pitfalls, it is recommended that companies genuinely attempt to direct their businesses from within the UAE rather than becoming satellite holding companies for businesses conducted in other countries. The UAE Ministry of Finance is expected to increase their supervision on companies situated in the UAE as it becomes a global financial hub in line with international reporting standards. ■

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