

Tax Alert

UAE



Synopsis of the new Corporate Tax Guide for Free Zone Person

On 9 December 2022, the UAE Ministry of Finance (MoF) released the UAE Corporate Tax (CT) law, which is applicable from the financial year commencing on or after 1 June 2023. Under the CT law, a Free Zone Person is considered a taxable person. However, a Qualifying Free Zone Person (QFZP) is eligible for a 0% CT rate if it fulfills specified conditions, which inter-alia include:

- Maintains adequate substance in the Free Zone
- Derives Qualifying Income
- Has not elected to be subject to CT
- Transacts with related parties at Arm's Length Price (ALP)
- Conducts audit of its books of accounts
- Meets de minimis requirements.

Furthermore, Cabinet Decision No. 100 of 2023 and Ministerial Decision No. 265 of 2023 were issued, clarifying various aspects, including coverage of Qualifying Income.

While this guidance was available, there were still certain open areas and questions that needed clarification to determine the taxability of Free Zone Companies.

In view of the same, on 20 May 2024, the Federal Tax Authority (FTA) issued a comprehensive CT Guide on Free Zone Persons, addressing some of the important issues.



We have summarized herewith in our alert the key aspects of the Free Zone Tax Guide:

Clarification with respect to Free Zones

Every Free Zone Person needs to check with the respective Free Zone Authorities to confirm whether they operate in a Qualified Free Zone/Designated Zone.

Election to opt for Free Zone Tax benefits is to be made in the tax return.

A Free Zone Person would cease to be QFZP if it has opted out of the Free Zone tax regime or fails to meet the conditions. However, it would be eligible to claim a 0% tax benefit after the expiry of the five-year period, subject to satisfaction of all the conditions in the 6th year.

Free Zone benefits are available to any juridical person registered in a Free Zone (i.e., whether it's a branch of any Foreign Company or any Mainland Company or Headquarter of any mainland or Foreign Company).

Free Zone Person is required to comply with the arm's length principle for transactions with Related Parties, including its Foreign Permanent Establishment (PE) or Domestic PE.

A person incorporated/established outside of a Free Zone cannot be a Free Zone person solely because the place of effective management and control of that juridical person is situated in the Free Zone.

Beneficial Recipient Concept

Transactions between a QFZP person and another Free Zone person are considered as Qualifying Income only where the recipient is the beneficial owner of the services/goods.

A Free Zone Person is considered the Beneficial Recipient of services or goods if the Free Zone Person has the right to use and enjoy the services or goods and is not bound by a contractual or legal obligation to supply such services or goods to another person. To be considered as the Beneficial Recipient, the services or goods must be for use by the Free Zone person and not by a Foreign PE or Domestic PE.

Where the recipient is acting as a conduit or intermediary (for example, an agent or nominee) for a third party (including a Related Party or group entity), the Beneficial Recipient of that transaction is the third party and not the conduit or intermediary.

Note: Seller can rely on a written statement or undertaking from the buyer on the Beneficial Recipient unless the seller has reason to believe otherwise.



Free Zone Company in start-up stage having No Income

Free Zone Person that does not earn any Qualifying Income in a Tax Period because it has not started to derive Revenue (i.e., during the initial set-up stage) will not be disqualified from being a QFZP, provided it does not derive any non-qualifying Revenue and complies with all other requirements prescribed by the CT Law.

Note: Interest income from a bank on surplus funds invested can be considered as a Qualifying Activity of treasury and financing services to Related Parties.

Maintaining Adequate Substance

Core income generating activity with respect to each Qualifying Activity to be performed in the Free Zone. Non-core activities related to business can be performed outside the Free Zone. Non-core activities would mean activities that don't derive sales or are routine in nature.

Substance may vary depending on the nature and size of the business. For example, a re-insurance company would need to be adequately capitalized in the Free Zone to support the level of risk that it assumes from other insurers or a headquarter services company should have a senior management team operating from the Free Zone.

For services outsourced to other Free Zone, the company would have to put in place adequate mechanisms to observe, oversee, assess and, instruct and provide guidance over the deliverables of the service provider.

Note: Adequate documentation, like contractual agreements on how supervision would be conducted both from a practical and technical perspective and, is to be maintained for outsourced activities.

Immovable and Commercial Property

Income derived from a mixed-use property located in a Free Zone shall be subject to CT at 0% and 9%, based on the use of the respective components of the property. For example, in a hotel building in a Free Zone, the Revenue should be allocated between the commercial and non-commercial units. This could be based on records of the relevant land registry department or some alternate basis (for example, rental or property value) that results in an arm's length allocation that is reasonable based on the facts and circumstances of each case.



Clarification on Qualifying Activities

Manufacturing of goods and materials

Full fledge manufacturing as well as contract/toll manufacturing, are covered in Qualifying Activities.

Manufacturing of goods includes: i) Product Planning, ii) Production, and iii) Quality Control.

Goods manufactured in UAE need not pass through the designated zone.

Ancillary activities include post-sale activities like installation, warranty, maintenance, upgrade, etc. and customer support services like warranty services and handling customer queries.

Note: 1) Ancillary activities do not include repairs as the same is classified as services.

2) Intangible items such as software that can be sold separately from a physical asset are not included in the definition of goods unless the software is embedded in hardware (example: television, smartphone, etc.)

Trading of Qualifying Commodities

Qualifying Commodities refer to metals, minerals, energy, and agriculture commodities that are traded in raw form in recognized commodity exchange markets.

Raw form typically refers to commodities that are in the natural and unprocessed state and no value has been added to the commodity grown/extracted/mined.

Some degree of processing involved to meet trading standards/specifications is to be ignored.

HSN code can be used as an indicator to verify whether a commodity still maintains its raw form.

Qualifying Commodities include buying a commodity at a lower price and selling at a higher price, as it involves a deep understanding of market trends and dynamics.

Ancillary activities include warehousing (i.e., storage and housing) and delivery (transportation).

Holding of shares and other securities for investment purposes

Major shareholders holding shares in a company for investment purposes deriving royalties or management fees from that company would not constitute income from the Qualifying Activity or ancillary activity.

Active trading of shares and other securities would not constitute a Qualifying Activity.

Transactions done through a Recognized Stock Exchange would be presumed to be not done with a natural person and hence will be treated as a Qualifying Activity, provided the 12-month ownership test is satisfied.

Note: Investment activity of holding shares includes investment planning, portfolio management and buying and selling securities.



Ownership management and operations of ships

Ownership of ships, management of ships and operation of ships might constitute Qualifying Activity.

Ship broking and, organizing and overseeing voyages might be treated as ancillary activities.

Ships used for local transportation or leisure recreational purposes or as floating hotels or casinos are not considered as Qualifying Activity.

Business solely consisting of maintenance, fit-out, or repairing ships is not considered a Qualifying Activity.

Fund management services

Fund management services might include: i) investment planning and strategy, ii) investment diversification, iii) Asset allocation, iv) Fund management, v) Performance monitoring.

Ancillary activities may include financial advisory. Training and education, financial planning, and technological support.

Wealth and investment management services

Wealth and investment management services would include: i) Portfolio management ii) Financial planning iii) Asset allocation.

Ancillary activities may include risk management, market research, investment analysis and family governance.

Single-family offices or multi-family offices would not be considered wealth and investment management services if not regulated by a competent authority.

Headquarter services

Activities that might constitute headquarters services to related parties: i) Taking relevant management/strategic decisions, ii) Incurring operating expenditure on behalf of group entities, iii) Co-ordinating group activities, iv) Financial Management, v) Central procurement services, vi) Human resource management, vii) Technical support viii) Legal and compliance services, ix) Intellectual property management.

Treasury and financing services to Related Parties

Treasury and financing services would include cash management, risk management, investment management and financing.

Shareholder loans fall under the scope of financing services with no threshold.

Any payment received (interest or service fee) as part of conducting treasury and financing services will be treated as a Qualifying Activity.

Interest income from bank deposits will be treated as arising from the Qualifying Activity of treasury and financing services to Related Parties.



Distribution of goods or materials in or from a Designated Zone

Distribution services should be performed vis-à-vis a customer that further resells or a person that processes the goods or part thereof for the purpose of resale (i.e., sale to end user would not be considered).

Distribution of goods or materials would include: i) Purchase and resale of goods or materials, ii) Warehousing, iii) Transportation, delivery and logistics, iv) Inventory management, v) Order processing, vi) Packaging and repackaging.

Ancillary activity might include Marketing and advertising, Quality control and inspection and Customer support services.

High Seas Sales are to be considered as a Qualifying Activity (i.e., goods not entering UAE) if conducted through a designated zone.

Goods not required to pass through the designated zone if the goods are manufactured in UAE or imported in UAE when sold by a QFZP from the designated zone to a company outside UAE.

Goods are required to pass through designated zones even if the goods are manufactured in UAE or imported in UAE when sold by a QFZP from a designated zone to a company within UAE.

Logistics services

Logistics services include: i) transporting goods, ii) warehousing, iii) inventory management, iv) declaration and documentation, v) freight forwarding services, vi) order fulfillment, vii) packing.

Logistic services do not include the movement of people.

Calculating CT for a Free Zone Person

If a Free Zone Person meets all the conditions (including the de minimis requirements) to be a QFZP, it will be subject to:

- 0% CT rate on its Qualifying Income and
- 9% CT rate on its Taxable Income that is not Qualifying Income.

A QFZP is not entitled to an exemption benefit of AED 375,000 on its Taxable Income.

To determine the amount of Taxable Income that is not Qualifying Income, which will be subject to the 9% CT rate, a QFZP will need to:

- Separate the Revenue in its Financial Statements into Revenue pertaining to the Qualifying Income component and to the Taxable Income component,
- Allocate the expenses in its Financial Statements against those components in a reasonable manner, consistent with the arm's length principle and



- Apply Article 20 of the CT Law (i.e., the general rules for determining Taxable Income) to determine the Taxable Income that is not Qualifying Income.

Where a QFZP derives both Qualifying Income and Taxable Income that is not Qualifying Income, it will need to allocate its expenses between the two components to determine the Taxable Income component. This should be done by applying the arm's length principle.

Income attributable to a Foreign PE or Domestic PE, requires the Foreign PE or Domestic PE to be treated as if it were a separate and independent Person transacting at arm's length ("separate entity approach"). In relation to income that is not connected with a Foreign PE or Domestic PE, the Free Zone Person should make a reasonable allocation between the components to determine the arm's length value of profits attributable to each activity.

A QFZP will not be able to benefit from:

- Small Business Relief
- Qualifying Group Relief

- Business Restructuring Relief
- the ability to transfer or receive a Tax Loss, or
- the ability to be a member of a Tax Group.

If a QFZP incurs Tax Losses on the Taxable Income component after applying Article 20 of the CT law, those Tax Losses may be carried forward and offset against the QFZP's Taxable Income in subsequent Tax Periods.

If a QFZP incurs losses in relation to the Qualifying Income component of its income, those losses may not be applied against the QFZP's Taxable Income, transferred or carried forward. A QFZP cannot transfer Tax Losses to, or receive Tax Losses from, another Taxable Person.

If a Free Zone Person does not meet the criteria to be a QFZP, the Free Zone Person will be subject to the standard CT rates from the beginning of that Tax Period.

Our Comments

Free Zone Guide clarifies various aspects and would help companies determine appropriate tax positions. It would be recommended for companies to re-look at the impact assessment already conducted to see if this guide requires any changes or re-alignment.

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