

# Corporate Tax Guide on Free Zone Persons

## Background

The Federal Decree Law No. 47 of 2022 on the Taxation of Corporations and Businesses ('UAE CT Law') provides for tax relief to Free Zone companies subject to satisfaction of conditions provided under the UAE CT Law read with Cabinet Decision No. 100 of 2023 and Ministerial Decision No. 265 of 2023.

The Federal Tax Authority ('FTA') has released the much awaited Corporate Tax Guide – CTGFZP1 on Free Zone Persons ('FZP Guide' or 'the Guide') to provide general guidance on the application of CT Law to Free Zone Persons.

This document summarises the key points of the Guide and its possible implications on the businesses operating in UAE.

## Overview of Free Zone Corporate Tax Rules

### General Rules

» The scope of the term Free Zone Person ('FZP') has been defined to include the juridical person as a whole and a FZP may:-

Have its Head Office in a Free Zone ('FZ') and have a branch outside the FZ, or

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### General Rules

Have a Head Office in the UAE outside a FZ or outside the country and have a branch within a Free Zone. In such a scenario, the Head Office could be generally considered a Domestic Permanent Establishment or a Foreign Permanent Establishment, respectively.

» It is clarified that in either of the above scenarios, **0% Corporate Tax rate will apply only to the Free Zone business**. The guide uses a unique term of 'Free Zone parent' to the operations that a FZ Person has within a FZ, and when it has a taxable presence outside of the Free Zone the term "Domestic Permanent Establishment" or "Foreign Permanent Establishment" is used to reflect its non-Free Zone Business.

» The Guide calls for the **taxpayers to check with their respective FZ Authorities and confirm if they are operating in the FZ or Designated FZ for CT purposes**.

» The guide clarifies that a **non-juridical person cannot be a Free Zone person**. Further, a juridical person incorporated outside a Free Zone cannot be considered as a Free Zone person merely because it is being effectively managed and controlled in a Free Zone.



## Requirements to be a QFZP

- » A FZP will be deemed to be a Qualified Free Zone Person ('QFZP') unless one of the conditions to be a QFZP is not met, or if QFZP makes an election to be subject to tax. The election can be made before the due date for filing the CT return for the first tax period. If a QFZP fails to meet the prescribed conditions or elects to be subject to tax, it would result in losing the status of QFZP from the beginning of that tax period and four subsequent tax periods. The conditions will have to be tested again in the 6th year and if the conditions are not met in that period as well, then the QFZP status will be lost for another period of 5 years.
- » To satisfy the test of beneficial recipient for FZ to FZ transactions, the goods or services must be for the use of the FZ person purchasing the same and a declaration or undertaking to this extent may be obtained from the recipient.
- » The guide reiterates the **de minimis** conditions to be satisfied and calculation of revenue with respect to the same along with a detailed flow chart and examples explaining the same.
- » It further clarifies that a **newly established FZP that does not earn any Qualifying Income in a tax period because it has not started to derive revenue will not be disqualified from being a QFZP**, and it can file CT return with QFZP status. However, in the case where a non-qualifying revenue exceeding de-minimis threshold (5% of total revenue or AED 5 mn) is earned, the QFZP status will be tainted for the current year and next 4 years.
- » The guide further emphasizes that the condition of transactions being at **Arm's Length and Transfer Pricing** should at all times be satisfied and appropriate Transfer Pricing documentation should be maintained.
- » A QFZP does not qualify for 0% rate on taxable income upto AED 375,000 and other reliefs under the UAE CT Law like the Tax Group, Small Business Relief, Qualifying Group Relief, Business Restructuring Relief and transfer of tax losses.

## Calculating CT for a FZP

- » The guide explains how to calculate Qualifying Income ('QI') and to determine the taxable income that is not QI which will be subject to tax at 9%. **QFZP needs to separate the revenue in its Financial Statements into QI and Taxable income** and allocate expenses against the said bifurcated revenues.
- » The guide further clarifies the approach to **attribute profit between FZ business and the Domestic/Foreign PE** by performing a functional analysis to attribute the profits and expenses. Where expenses cannot be directly attributed, allocation of expenses needs to be at arm's length.
- » It is clarified that the **tax losses incurred on the taxable income component by a QFZP can be carried forward and offset against the QFZP's taxable income in subsequent years**, except against income from Intellection Property.

## Adequate Substance

- With respect to maintaining adequate substance, the guide has specifically addressed the following areas:
- » Substance to be maintained **within the geographical area of the FZ / Designated FZ** from where the business activity is undertaken.
- » Mere routine activities (that do not directly drive the revenue) would not be considered as Core Income Generating Activities ('CIGA'). An entity would be considered as having **met the substance test even if such routine activities are performed outside the FZ / DFZ, given that the CIGA are performed from within the FZ / QFZ**.
- » **The substance test is required to be satisfied for CIGA with respect to each Qualifying Activity.**
- » Location from where the key strategic decision is made shall be the basis for determining substance.
- » Adequate substance will depend on the nature and size of each business. An example is given that the holding company may not have any employees but if the Board of Directors perform key decision making in FZ, substance will be met.

- » Adequate number of employees are required to meet substance. **Double counting of employees is not allowed.** One employee can perform multiple activities, but each CIGA requires its own substance.
- » CIGA may be outsourced **only to another FZP**, provided the QFZP has **adequate supervision** over the outsourced activity, except in case of Qualifying Intellectual Property (IP) business wherein CIGA can be outsourced to any person in UAE or any person outside UAE that is not a Related Party. Further appropriate mechanisms should be available to demonstrate supervision like contractual agreements and appropriate documentation.

**Note:** Various illustrations have been given in the Guide to provide more clarification on the substance requirement. The assessment has to be made on a case-to-case basis.

### Foreign PE or Domestic PE

- » **Foreign/Domestic PE is treated as a separate independent non Free Zone person.** Foreign PE is a place of business of presence outside the UAE of a resident person. A resident person, including a FZP, **may elect to not take the income of Foreign PE** into account while determining its taxable income, subject to meeting the conditions prescribed by the UAE CT Law.
- » Domestic PE is a place of business or presence of a QFZP outside the FZ in the UAE. In case a QFZP has its Head Office in a FZ and a branch in mainland, the branch may be treated as Domestic PE and if a QFZP has its Head Office in mainland and branch in FZ, then the Head Office will be treated as Domestic PE.

### Immovable Property



Only income from another FZP in respect of commercial property in the FZ will be QI and income from any other immovable property will be taxable at 9%.

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Income from **mixed use of property** in a FZ is to be allocated to QI and non-QI.

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Income from **property located outside FZ** is a **non-QI** and will have to be taken into consideration while applying the de minimis test, unless the income is attributable to Domestic or Foreign PE.

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### Intellectual Property

- » **Qualifying Intellectual Property ('QIP')** means any patents, copyrights and any other equivalent rights that is both legally protected and subject to similar approval and registration process, however, does not include any marketing intangibles like trademarks, etc.
- » QFZP must be able to **track income and expenses associated with the QIP**. It needs to be determined whether the income and expenses are to be tracked for each asset or product or by product family basis as the same will also impact as to how the R&D is to be tracked.
- » **R&D costs to include all costs directly associated with the R&D facility.** If R&D activities are outsourced, the qualifying expenditures are to be determined on the same basis as if the activities are undertaken by the QFZP itself.

- » The guide provides methodologies to determine Qualifying Expenditure and Overall Expenditures. Qualifying expenditures to include expenditures at the time they are incurred, irrespective of the accounting/tax treatment followed for the same.
- » For a QFZP in existence prior to the introduction of the UAE CT Law, qualifying and overall expenditures can be calculated based on a three year rolling average.
- » It is stated that a QFZP must maintain all records and documentation with respect to calculation of income and expenditures and should be able to provide justification for using the approach in terms of tracking the income and expenses with respect to the QIP.

## Qualifying Activities:

The Guide has elaborated along with illustrations on the scope of each Qualifying Activities along with the scope of ancillary activities. Major clarifications addressed by the Guide are detailed below:

### Manufacturing of Goods or materials:

- » Manufacturing to **include full-fledged manufacturing as well as contract or toll manufacturing.** It not only includes production of new goods but also improving or assembling pre-existing components.
- » Goods manufactured in UAE **do not need to pass through Designated FZ.** However, the distribution activity is required to be conducted in or from a Designated Zone in order to be a Qualifying Activity.  
Manufacturing does not include repairs.
- » **Intangible items** (like software, ERP, automation tools) that can be sold separately are not considered as goods, and hence are **not considered as a Qualifying Activity.** However, **software embedded in hardware on the other hand are considered as goods.**
- » Activities such as installation, warranty, maintenance, etc. can be considered as ancillary activities.

### Processing of goods or materials:

- » Processing is a wider concept than manufacturing and may occur where an item undergoes a process but essentially remains the same thing, and **no new product is created.**
- » It includes preparation, treatment, transformation or conversion of goods or materials into another form of good or material for further commercial or industrial use or sale.
- » Post sale activities and customer services may be treated as ancillary activities.

### Trading of Qualifying Commodities:

- » The Qualifying Commodity needs to be in a form that is traded on Recognized Commodities Exchange Market. However, the **actual trade need not be performed through the exchange.**
- » Raw form has been defined to mean a commodity in natural or unprocessed state, where no value addition has been made but **may include commodities that have undergone minimal processing to ensure quality and uniformity standards.**
- » HSN code can serve as an indicator in verifying if a commodity still maintains its raw form.
- » Activities of delivery and warehousing may be considered as ancillary.

#### **Holding of shares and other securities for investment purposes:**

- » It includes holding of various types or classes of shares and securities which are held for an **uninterrupted period of 12 months (actual or if intended to hold for more than 12 months)**. **Crypto currencies** have been specifically included within the meaning of shares and other securities.
- » Trading of shares and securities on a Recognized Stock Exchange is not presumed to be made with a natural person, and hence, will be treated as a Qualifying Activity, provided the condition of 12 months holding period is satisfied.
- » Income from indemnity claims, etc from the securities held will also be considered as QI.

#### **Ownership, Management and operations of ships:**

- » It includes ships used in the **international transportation (i.e. movement beyond the territorial waters of UAE)** of passengers, goods, livestock but does not include ships used for local transportation or leisure or recreational purposes such as floating hotels, restaurants, casinos, etc. It includes ships used in providing offshore oilfield and maritime services.
- » Transportation between 2 ports of UAE to be considered international transportation provided the broader itinerary includes transportation to ports outside UAE.
- » The guide further defines each of the terms ownership, management and operation of ships. **Transactions with natural persons not to be treated as Excluded activities.**

#### **Reinsurance Services :**

- » It includes activities of underwriting premiums, claim handling and management, assuming all or part of the risk undertaken by another insurer or reinsurer, **provided the reinsurance activity is subject to regulatory oversight of the Competent authority in UAE.**
- » Income from reinsurance related advisory services, investing activities out of the premiums received till the time claims are to paid out, etc. may be considered ancillary activities.

#### **Fund management services:**

- » Includes managing a specific portfolio of investments on behalf of third-party investors and the services should be **subject to the regulatory oversight of the relevant Competent authority of UAE** (like Central Bank of UAE, DFSA, FSRA, etc).
- » The **decision of where to invest should be taken solely by the fund manager**, having in-depth knowledge of financial markets and economies and will include activities that are delegated by a Fund manager to an investment advisor or sub-advisory.
- » Services provided to natural persons will not be treated as Excluded activities.

#### **Wealth and investment management services:**

- » It includes more holistic services and differs from fund management because it extends beyond just investing and includes retirement planning, estate planning, tax planning, budgeting and so on. Services should be subject to regulatory oversight of Competent authorities in UAE.
- » Services provided to natural persons are not Excluded Activities.

#### **Headquarter services to Related Parties:**

- » It includes activities like administering and overseeing the business of related parties, providing senior and general management services, business planning and development, etc.

- » Reference to related parties is limited to **juridical persons and its branches** including domestic/foreign PE. **Services may be provided to Related Parties who are either residents or non-residents.**
- » It is clarified in one of the examples **that procurement and sale of goods to related parties will not qualify under this activity** and may be tested under the Distribution activity separately.

#### **Treasury and financing services to Related Parties:**

- » Treasury and financing services includes cash pooling and centralised payment/cash collection activities for or on behalf of Related Parties and **self-investment** (i.e. self investment of funds in banks deposits, etc. will also qualify). It will also include shareholder loans.

#### **Financing and leasing of aircraft:**

- » Activities related to agreeing funding terms, acquisition, lease management, including subleasing will also be covered.
- » Financing and leasing of aircraft to natural persons will not be excluded activity.

#### **Distribution of goods or materials from DZ:**

- » It involves **holding title to the products**. Activities of a **sales agent / consultant** who is not involved in the actual buying / selling of goods or materials is **not considered as Qualifying Activity**.
- » **Scenarios covered:** -
  - » **High Sea Sales/Third port shipments** (Bill to Ship to model) – Goods purchased from Country A and sold to country B (not end users) and shipped directly from A to B.
  - » **Distribution within UAE** – Goods imported from outside UAE and sold in UAE (not end users).
  - » **Distribution from UAE** – Goods purchased from UAE (outside Free Zone) and sold/exported outside the UAE (not end user).
  - » **Local UAE Distribution** – Goods purchased from UAE and sold within UAE (not end user)
- » Onus is on the distributor to ensure that the **purchaser is not the end user** (distributor to exercise due diligence by performing Know your client procedures (KYC)).
- » **Intangible products** like softwares, licenses, etc. **are excluded**, except if any goods have embedded software which cannot be separately identifiable.
- » Marketing, Advertising, Quality control, customer support services, etc. may be ancillary activities.

#### **Logistics services:**

- » It includes **storage and transportation of goods or materials** on behalf of another person without taking title to the good or material of that other person. It does not include movement of people.
- » There are no limitations prescribed for the mode of delivery.
- » Where the Free Zone Person performs most of its logistics services within a Free Zone for its customers in the UAE outside a Free Zone or foreign customers but provides last mile delivery services outside of the Free Zone in the UAE or in a foreign country, **the last mile delivery services will still form part of the Free Zone Person's logistics services Qualifying Activity.**

## Compliance:

- » QFZP is also required to maintain records for period of 7 years.
- » Tax Registration is mandatory as per the timelines prescribed even for a QFZP.
- » Applicable accounting standards to be followed.
- » QFZP has to mandatorily prepare audited financial statements, irrespective of the turnover.
- » Filing of Tax Return is mandatory in the form and manner prescribed by FTA within 9 months from the end of the relevant Tax Period.

## Our Comments & Concluding Thoughts :

- » The guide provides much awaited clarifications and guidance to the businesses in Free Zones.
- » Certain clarifications have provided a sigh of relief to businesses by helping them to determine if the activities conducted by them would be Qualifying Activities (like income from self-investments, distribution income from third port shipments, income from trading of qualifying commodities, holding of crypto currencies as investments, etc). This is a welcome step.
- » However, the guide has re-emphasized the importance of maintaining adequate substance and compliance with Transfer Pricing provisions. It is important for businesses to not only focus on satisfying the condition of conducting Qualifying Activities but also equally focus on other conditions and nuances to be satisfied to avail the status of QFZP.
- » Such other conditions like meeting substance is to be tested based on facts of each case and need to be analysed on case to case basis as it may significantly differ basis the nature and size of each business.

## Way Forward :

In view of the detailed clarifications provided by the guide, it is important for the businesses in Free Zones to conduct a detailed analysis of the applicable provisions to their businesses. Further, the concluded impact assessments should also be revisited in light of the clarifications and guidance provided in the guide.

In case you require any assistance or further insights, you may please reach out to our team. We will be happy to assist.



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