

Taxability of Qualifying Free Zone under UAE Corporate Tax Law



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The United Arab Emirates' ("UAE") Ministry of Finance ("MoF") issued the Federal Decree-Law No. 47 of 2022 ("UAE CT Law") on 3 October 2022 (published in public domain in December 2022).

Article 18 read with clause 2 of Article 3 of the UAE CT Law provides for the broader framework on the taxation of Qualifying Free Zone Person ("QFZP").

The key parameters of the above articles as under:

1. QFZP is the juridical person incorporated, established or registered in the Free Zone ("FZ") meeting **all** the below conditions (hereinafter referred to as 'primary conditions'):
 - Maintains adequate substance in UAE;
 - Derives Qualifying Income (which was to be defined by separate Cabinet Decision);
 - Not elected to be subject to regular CT rate;
 - Complies with Arm's Length Principle ("ALP") and maintains Transfer Pricing Documentation ("TPD"); and
 - Meets any other conditions as prescribed by the Minister (under separate Ministerial Decision)
2. QFZP would be subject to tax as under:
 - 0% on Qualifying Income
 - 9% on taxable income that is not Qualifying Income.

Recently, MOF has released two Decisions relevant to the taxation of the QFZP, namely, Cabinet Decision No. 55 of 2023 on Determining Qualifying Income and the Ministerial Decision No 139 of 2023 on Qualifying Activities and Excluded Activities.

The Cabinet Decision essentially deals with (i) defining Qualifying Income and De Minimus Requirements, and (ii) taxation of incomes attributable to Domestic and Foreign Permanent Establishment ("PE") and certain categories of Immovable Properties.

Whilst, the Ministerial Decision deals with (i) defining Qualifying Activities and Excluded Activities for the purposes of Qualifying Income, (ii) providing threshold for De Minimus Requirements and (iii) stating additional conditions for QFZP.

Relevant definitions are reproduced later in this article.

Key highlights of the Decisions are as under:

➤ **Additional primary condition for QFZP eligibility**

- Non-qualifying revenues should not exceed AED 5 million or 5% of the total revenues of the QFZP, whichever is a lower
- Maintaining Audited Financial Statements

QFZP shall cease to be QFZP for the total period of 5 years for the non-compliance of above conditions read with other primary conditions.

➤ **Qualifying Income – being subject to tax at 0%**

The Decision focusses on three parameters which define the Qualifying Income as under:

1. Transactions with other FZ persons except from Excluded Activities
2. Transaction with non-FZ persons in respect of Qualifying Activities not being Excluded Activities
3. Any other income satisfying the De Minimus Requirements

The De Minimus Requirements is considered as satisfied when Non-Qualifying Revenues earned by a QFZP does not exceed, the lower of:

- 5% of total revenues, **OR**
- AED 5 million

Where the Non-Qualifying Revenues are the revenues earned by QFZP from:

- Excluded Activities, **and**
- Non-Qualifying Activities with non-FZ persons.

Note: It shall be noted that the income derived from the above transactions shall be Beneficially Received by the QFZP which essentially mean that the QFZP has the right to use and enjoy the service or the good and does not have a contractual or legal obligation to pass on such service or good to another person.

➤ **Taxable Income that is not a Qualifying Income – being subject to tax at 9%**

The Decision carves out two streams of income earned by QFZP and treats them as taxable income subject to tax at 9%, as under:

1. Income attributable to Domestic or Foreign Permanent Establishment of the QFZP
2. Income attributable to immovable property location in the FZ that is derived from the below transaction:
 - Transactions with Non-FZ persons in respect of Commercial Property
 - Transactions with any persons in respect of immovable property not being a Commercial Property

Where the Commercial Property has been defined as "Immovable property or part thereof:

(a) used exclusively for a Business or Business Activity.

(b) not used as a place of residence or accommodation including hotels, motels, bed and breakfast establishments, serviced apartments and the like.”

Note: It shall be noted that the above taxable income shall not be considered for the purpose of calculation under De Minimus Rule.

➤ **Adequate Substance**

The Decision now specifically defined adequate substance (which is broadly aligned with the substance requirements under the existing economic substance regulations) as undertaking Core-Income Generating Activities (“CIGAs”) **in the FZ**, having regard to:

- Adequate assets,
- Adequate number of qualified employees,
- And adequate operating expenditures

Simultaneously, the Decision also permits outsourcing of the CIGAs to related or third party, provided that outsourced activities as also undertaken **in the FZ**.

PB Comments

- The Decisions, which were awaited the long, appears to be incentivizing specific sectors or businesses such as shipping, manufacturing, logistics, aviation and certain financial services. However, it puts the business community in thoughts for certain business models, especially in the distribution segment.
- While it is clear that the Free Zone person undertaking the distribution in or from the Designated Zone (“DZ”) and clearing the goods through the DZ for onward sale, not being the sale to end consumer, to Non-FZ person (which could be mainland entity or foreign entity) qualifies as ‘Qualifying Activity’, there remains open interpretations in respect to below:
 - Whether high sea sales qualify as Qualifying Activity?
 - Whether local sourcing and related exports through DZ qualify as Qualifying Activity?
 - Whether incoterms (such as ex-works) play an important role to determine the place of sale?
- As regards the services, it appears that majority of the services are kept out of the Qualifying Activity list or include in Excluded Activity list, due to their geographically mobile nature.
- In months to comes, it is also expected that the Ministry may comes out with atleast one more Decision notifying the ‘Free Zones for the purposes of Corporate-tax’.
- As regards the income from immovable property located within the FZ, it appears that the intention is to tax the revenues streams connected with said property, if used for dwelling purposes in any form.
- The businesses are expected to pay greater attention to De Minimus Rule as it could have the potential to withdraw the 0% rate advantage to QFZP if the required thresholds are not met.

Where it is expected that the thresholds shall not met on account of particular business model, the businesses may evaluate to opt-out of the QFZP regime from the beginning and be subject to regular CT rate.

- Whilst the Decision excludes the revenues from the Domestic PEs of QFPZ, being the Head Office of Domestic PE for limited purpose, from the calculation for De Minimus Rule, profit attribution exercise (using the transfer pricing approach) could be a challenge considering the subjectivity involved, and presence of common costs.

We strongly recommend undertaking the impact assessment study to the businesses contemplating to opt for 0% rate regime applicable for QFZP.

Definitions:

➤ **Qualifying Activities:**

The following activities are referred as 'Qualifying Activities':

- (a) Manufacturing of goods or materials.*
- (b) Processing of goods or materials.*
- (c) Holding of shares and other securities.*
- (d) Ownership, management and operation of Ships.*
- (e) Reinsurance services that are subject to the regulatory oversight of the competent authority in the State.*
- (f) Fund management services that are subject to the regulatory oversight of the competent authority in the State.*
- (g) Wealth and investment management services that are subject to the regulatory oversight of the competent authority in the State.*
- (h) Headquarter services to Related Parties.*
- (i) Treasury and financing services to Related Parties.*
- (j) Financing and leasing of Aircraft, including engines and rotatable components.*
- (k) Distribution of goods or materials in or from a Designated Zone to a customer that resells such goods or materials, or parts thereof or processes or alters such goods or materials or parts thereof for the purposes of sale or resale.*
- (l) Logistics services.*
- (m) Any activities that are ancillary to the activities listed in paragraphs (a) to (l) of this Clause.*

In application of paragraph (k) of Clause (1) of this Article, the activity of distributing goods or materials must be undertaken in or from a Designated Zone and the goods or materials entering the State must be imported through the Designated Zone.

➤ **Excluded Activities:**

The following activities are referred as 'Excluded Activities':

- (a) Any transactions with natural persons, except transactions in relation to the Qualifying Activities specified under paragraphs (d), (f), (g) and (j) of Qualifying Activities.
- (b) Banking activities that are subject to the regulatory oversight of the competent authority in the State.
- (c) Insurance activities that are subject to the regulatory oversight of the competent authority in the State, other than the activity specified under paragraph (e) of Qualifying Activities.
- (d) Finance and leasing activities that are subject to the regulatory oversight of the competent authority in the State, other than those specified under paragraphs (i) and (j) of Qualifying Activities.
- (e) Ownership or exploitation of immovable property, other than Commercial Property located in a Free Zone where the transaction in respect of such Commercial Property is conducted with other Free Zone Persons.
- (f) Ownership or exploitation of intellectual property assets.
- (g) Any activities that are ancillary to the activities listed in paragraphs (a) to (f) of this Clause



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Address

Office 805, 8th Floor,
Exchange Tower,
Business Bay,
Dubai, UAE

Contact Info

+971 4 354 2959
info@premier-brains.com
www.premier-brains.com

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