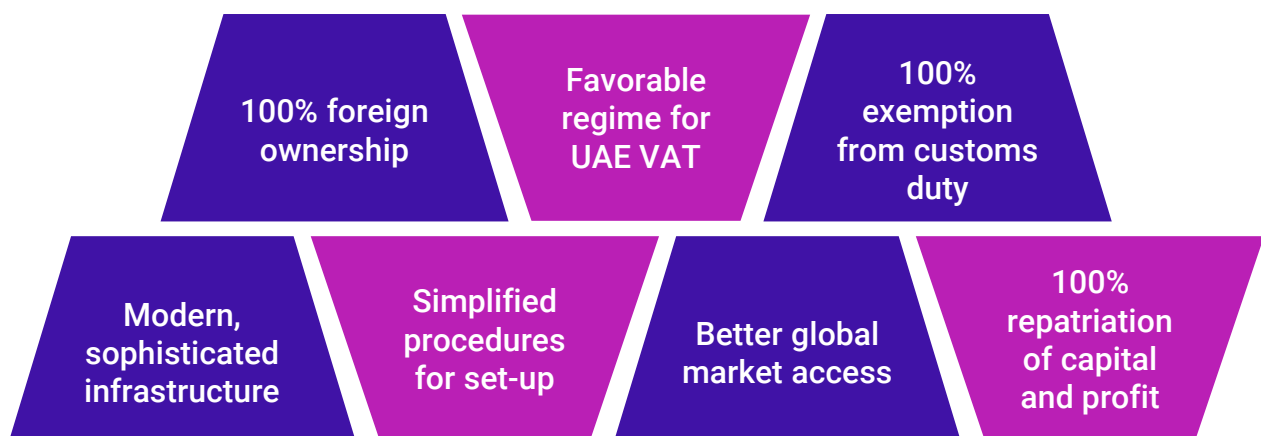


Free zone companies free of Corporate Tax?

UAE makes an attractive investment destination for foreign investors, largely due to its favorable geographical location, economic and political stability, progressive business regulations, and diverse talent pool.

However, the Free Zones, the separate designated areas for business where special corporate and tax regulations are applicable, make UAE a popular business hub.

Benefits of Free Zones for Foreign Investors



UAE Corporate Tax (CT) in Free Zones



Original Recommendation – As per Public Consultation Document

When the CT regime was announced on 31 January 2022, the UAE Ministry of Finance (MoF) stated that they would honor the tax incentives available to entities in the Free Zones of UAE. Thereafter, a Public Consultation Document was released on 28 April 2022, which provided glimpses of the new federal tax law and made it clear that entities in Free Zones would be within the scope of CT and would be required to register under the said regime and file tax returns. However, they would be eligible for a 0% CT rate subject to fulfillment of prescribed conditions pertaining to maintaining substance and complying with the respective Free Zone regulations.

As per the said document, the following income of Free Zone persons would be subject to 0% CT:

- Income from outside UAE or from other Free Zones
- Passive income from mainland companies (royalties, interest, etc.)
- Income from group companies in the mainland is subject to a disallowance of expenses in the hands of mainland companies.

The document also specified that Free Zone persons not fulfilling requisite conditions or earning any other income from the mainland would result in losing out on exemption, and entire income would become subject to CT. The taxation of entire income in case of violation of the condition appeared to be harsh for companies having income from the mainland.

Provisions for a Free Zone person under the final CT law

Finally, on 9 December 2022, the UAE MoF released the final version of the CT law. Under the final CT law, a Free Zone person is included in the definition of taxable persons. Furthermore, the beneficial tax regime would apply only to a qualifying Free Zone person earning qualifying income.

As per Article 18 of the final law, a qualifying Free Zone person means an entity in the Free Zone that:

- Maintains adequate substance.
- Derives qualifying income as may be specified.
- Complies with transfer pricing provisions of the law.
- Has not elected to be subject to CT, and
- Meets such other conditions as may be prescribed.

A Free Zone person that fails to meet the aforesaid conditions at any time during a tax period shall cease to be a qualifying Free Zone person from the beginning of that tax period. Furthermore, a Free Zone person shall be taxed at 0% on its qualifying income and at 9% on all income other than qualifying income. It appears that the income threshold of AED 3,75,000 may not be available to Free Zone persons. A qualifying Free Zone person can make an application to be subject to CT at rates applicable to other taxable persons.

Currently, the term qualifying income is not defined, but it looks like the same should be in line with what was provided under the Public Consultation Document (i.e., income from Free Zones, exports and passive income from the mainland may be considered as qualifying income). Notification on qualifying income is currently awaited.



Important Aspects to be kept in mind by Free Zone persons in UAE

- A Free Zone person has the option to elect to be taxed as per the normal provisions.
- Free Zone persons would be required to adhere to the arm's length principle and maintain adequate transfer pricing documentation providing disclosure of transactions with related parties and connected persons.
- However, Free Zone persons cannot be a part of tax groups and they are also not eligible for tax relief on intra-group transfers and restructuring. Also, the transfer of tax loss to or from a Free Zone person is also not permissible.
- Free Zone companies, especially ones that are part of large groups, would have to carefully evaluate the pros and cons of opting out of the exemption, as it's a one-time option.
- Given that Free Zone Companies' income would be classified in Qualified Income and other income, it would become imperative for companies to have appropriate break-up/allocation of expenses incurred for earning qualifying income and other income.
- Furthermore, the FAQs released by the MoF have also clarified that qualifying Free Zone entities that are part of a large multinational group are anticipated to be subject to a different CT rate once the Pillar Two rules are embedded into the UAE CT regime.

Other aspects that need clarity are as follows:

- Whether Free Zone Companies complying with the Economic Substance Regulations in UAE could be said to have maintained adequate substance, or they may have to provide proof of substance in any other manner?
- Whether the transactions eligible for 0% CT rate, as specified in the Public Consultation Document would continue to appear in the cabinet decision?
- Whether certain specified Free Zone person would be mandated to get their books audited?
- Whether any further relaxations are expected for Free Zone Companies liable to tax on qualifying income?

Our Comments

Free Zones attract a large amount of foreign investment in the UAE. Therefore, the applicability of UAE CT law to Free Zone persons has been kept rational. However, restrictions in availing group tax reliefs and possible taxation of transactions with the mainland would deter the investors especially considering the opening of Foreign Direct Investment in UAE.

The transfer pricing requirement and substance requirement would be critical for Free Zone Companies as they will have to carefully evaluate their current structure and transfer pricing policies to ensure that they don't lose out on the benefit.

With UAE CT law coming into force from the financial year beginning on or after 1 June 2023, companies need to align their financial systems to ensure that they are in compliance. Going forward, all eyes would be on the cabinet notification for qualifying income. It would be interesting to see if it is in line with Public Consultation Document or if it would throw up a few surprises.



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We provide integrated, digitally driven solutions encompassing Business and Professional Services, that help companies navigate challenges across all stages of their life-cycle. Through our direct operations in the USA, Poland, UAE, and India, we serve a diverse range of clients, spanning multinationals, listed companies, privately-owned companies, and family-owned businesses from over 50 countries.

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From inception, our founders have propagated a culture that values professional standards and personalized service. An emphasis on collaboration and ethical conduct drives us to serve our clients with integrity while delivering high quality, innovative results. We act as partners to our clients, and take a proactive stance in understanding their needs and constraints, to provide integrated solutions. Quality at Nexdigm is of utmost importance, and we are ISO/ISE 27001 certified for information security and ISO 9001 certified for quality management.

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