UAE Corporate Tax Regime Impact on Free Zone Entities

The UAE Corporate Tax Law (CT Law) is effective for any financial year beginning on or after 1 June 2023 (i.e., for a company following calendar year, the first tax year would be 1 January 2024 to December 2024).

The CT Law is applicable to any juridical person incorporated in the UAE including Free Zone Entities (this includes companies, firms, LLPs, unincorporated JVs, etc.) and natural person carrying on business activities. Furthermore, any juridical person incorporated outside the UAE but effectively managed from the UAE would also be considered as a resident for UAE corporate tax purposes.

Non-residents would be taxed in the UAE in respect of their income derived from a Permanent Establishment (PE) in the UAE or in respect of income derived through a 'Nexus' in the UAE.

Corporate tax shall be imposed on a taxable person at the rate of 9%.

A Qualified Free Zone Person (QFZP) would be liable to a 0% corporate tax on its qualifying income and 9% tax on non-qualifying income.

UAE CT impact on Free Zone Entities

A Free Zone person, to avail 0% corporate tax benefits, has to first become a QFZP. In order to become a QFZP, the following conditions are required to be satisfied:

- Should be part of the Free Zone which is recognized as a qualifying Free Zone.
- Should maintain adequate substance in the Free Zone (i.e. have sufficient operations, employees, and directors on the ground in the Free Zone).
- Should not have elected to be subject to corporate tax.
- Should comply with the arm's length principle for related party transactions and connected persons.
- Should earn/derive 'Qualifying Income'.
- Prepare and maintain audited financial statements.
- Comply with any other conditions as may be prescribed.

The term 'Qualifying Income' has now been defined by way of Cabinet Decision No. 100 read with Ministerial Decision No. 265 of 2023.

- A person shall be said to be earning Qualifying Income if his income is derived from:
  - Transactions with other Free Zone persons, other than income from excluded activities[1].
  - Transactions with non-Free Zone persons (including non-UAE customers) only in respect of qualifying activities[2] which are not excluded activities.
- In case a QFZP earns non-qualifying revenue[3], then the same should not exceed 5% of their total revenue or AED 5 million, whichever is lower.
- In case of failure to meet the above conditions, a Free Zone person shall cease to be a QFZP for that tax period and the subsequent four tax periods.

Compliance Requirement for a Free Zone Company

- All Free Zone persons (including ones subject to 0% tax rate) shall be required to undertake following compliances:
  - Obtain corporate tax registration
  - Get their accounts audited
  - File tax returns
  - Ensure transactions with related parties/connected persons are based on the arm's length principle. Transfer Pricing (TP) documentation (such as master file, local file) must be maintained subject to certain conditions[4].

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

Ensuring that QFZP has substance in the Free Zone will be very critical. It is important to note that unlike Economic Substance Regulations (ESR), UAE CT Law requires entities to have substance within the Free Zone. Accordingly, companies would have to evaluate the level of activity, assets, and employees present in Free Zones and not in the UAE.

QFZP cannot be a part of tax groups, transfer tax losses, or claim small business relief. Furthermore, QFZP are not eligible for tax relief on intra-group transfers and restructuring.

Free Zone exemption is now activity-based and hence, it becomes very critical for Free Zone companies to evaluate whether they qualify for 0% corporate tax or not. In case they are not qualifying for the exemption, then it would be important for them to evaluate whether there is any opportunity to restructure the business or evaluate the pros and cons of opting out of the exemption.

While the Qualifying Income and excluded activities have been defined, there are still certain areas which may require clarifications, especially on what would be the definition of certain terms such as securities, wealth management services, headquarter services, trading businesses, etc. Accordingly, it would be important to conduct a detailed impact assessment based on the business activities conducted by the company.

Free Zone persons would be required to adhere to the arm's length principle and maintain adequate TP documentation. It would become imperative for businesses to review their inter-company transactions, formulate a transfer pricing policy, and maintain relevant documents/records to substantiate its position on transfer pricing.

Furthermore, the CT Law provides that Qualifying Free Zone Persons that are part of a large multinational group[5] are to be taxed at 15% in line with OECD BEPS Pillar Two. Detailed guidance will be released shortly.

1. Excluded activities include any transactions with natural persons (except for certain specified activities), banking activities, insurance activities, finance and leasing activities, ownership and exploitation of immovable property (specific cases), and any activity ancillary to the above.
2. Manufacturing and/or processing of goods, trading of qualifying commodities, holding of shares and securities, operation and management of ships, re-insurance services, fund management, wealth and investment management, headquarter services and treasury services to related parties, financing and leasing of aircrafts, distribution of goods through designated zones, logistic services, and any activity ancillary to the said services.
3. Non-qualifying revenue means revenue from excluded activities or from activities which are not qualifying and where the other party is a non-Free Zone person. However, revenue attributable to domestic and foreign PEs of a Free Zone person shall not be included and certain immovable property transactions shall not be included in non-qualifying revenue.
4. Revenues in a relevant tax period of at least AED200 million, or they are part of an MNE group with a total consolidated group revenue of at least AED 3.15 billion in the relevant tax period.
5. MNE Groups which have consolidated revenues in excess of AED 3.15 billion

Free Zone Entities – Next Steps

- Evaluate whether your entity is complying will all the conditions to be considered as a QFZP. This would include reviewing substance in the Free Zone, formulation of a transfer pricing policy for transaction with related parties/connected persons, etc.
- Review the nature of activities, types of customers, etc. to determine whether your entity is earning Qualifying Income or not. Identify areas for restructuring to ensure you optimize your tax costs in the UAE.
- In case your entity is liable to tax, examine your accounting policies, deductible expenses, etc. to optimize your tax costs.
- Entities with overseas subsidiaries and investment holding companies would have to evaluate participation exemption eligibility and also ensure that there is no risk for subsidiaries/investments to become a resident in the UAE due to their control and management being in the UAE.
- Plan and prepare for corporate tax implementation after conducting a detailed impact assessment to ensure that your entity is on the right side of the law and geared up for compliances from an operational as well as legal perspective.

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