

## Corporate Tax Alert

# Taxability of Free Zone Persons



## Corporate Tax Alert: Taxability of Free Zone Persons

As per the UAE Corporate Tax Law<sup>[1]</sup> ('UAE CT Law'), a Qualifying Free Zone Person ('QFZP') would be taxed at the following rates:

- 0% on its **qualifying income**; and
- 9% on its taxable income that is not qualifying income

Subsequently, Cabinet Decision No. 55 of 2023 and Ministerial Decision No. 139 of 2023 (collectively referred as 'erstwhile FZ Decisions') were released, which dealt with aspects related to determination of qualifying income for a QFZP and what activities will be considered as qualifying activities and excluded activities.

The Ministry of Finance ('MOF'), thereafter, released a consultation paper ('PCD on FZ') on the application of corporate tax on free zone entities and to seek views and obtain inputs on aspects related qualifying activities and excluded activities along with certain illustrations.

Pursuant to the PCD on FZ, the MOF has released new implementing decisions related to Free Zone - Cabinet Decision No. 100 of 2023 and Ministerial Decision No. 265 of 2023 (collectively referred as 'updated FZ Decisions'). The updated FZ Decisions are effective from 1 June 2023 onwards and the erstwhile FZ Decisions have been repealed as a result.

We have summarized the key updates in the updated FZ Decisions hereinbelow:

### A. Key Updates

S. No.	Aspects	Erstwhile FZ Decisions and PCD on FZ	Updated FZ Decisions
1	Scope of Qualifying Income expanded to include income derived from ownership and exploitation of Qualifying Intellectual Property ('QIP')	<p>The erstwhile FZ Decisions provided that Qualifying income of a QFZP included the following income:</p> <p>a) Income derived from transactions with other FZP except income from Excluded Activities</p> <p>b) Income derived from transactions with non-FZP (i.e., mainland &amp; overseas entities) but only in respect to Qualifying Activities that are not Excluded Activities</p> <p>c) Any other income subject to meeting De Minimis requirements - which will be considered as satisfied if non-qualifying revenue derived by QFZP in a tax period is lower of:</p> <ul style="list-style-type: none"> <li>- 5% of the total revenue; or</li> <li>- AED 5 million.</li> </ul>	<ul style="list-style-type: none"> <li>• The scope of 'Qualifying Income' has now been <b>expanded</b> to include 'income derived from ownership and exploitation of QIP'. <ul style="list-style-type: none"> <li>- <i>The definition of QIP does not include marketing related property assets such as trademarks. Patents and Copyrighted Software are included.</i></li> <li>- The updated FZ Decisions prescribes a methodology for calculating qualifying income derived from the ownership or exploitation of QIPs ('prescribed amount'). Refer to section B for details on this aspect.</li> <li>- Income from the ownership or exploitation of intellectual property other than QIPs or income <u>in excess of</u> the prescribed amount will be taxed @9%</li> </ul> </li> </ul>

[1] Federal Decree-Law No. 47 of 2022 on the Taxation of Corporation

S. No.	Aspects	Erstwhile FZ Decisions and PCD on FZ	Updated FZ Decisions
2	Incidental income and Ancillary Activities	<p>The erstwhile FZ Decisions had provided that 'Qualifying Income' will include incidental income to - a) income earned from another FZP and, b) qualifying income from non-FZP.</p> <p>The list of 'Qualifying Activities' and 'Excluded Activities' included ancillary activities to the main activities. Ancillary activity was defined to mean an activity shall be considered ancillary where it serves no independent function but is necessary for the performance of the main qualifying / excluded activity.</p>	<ul style="list-style-type: none"> <li>• Incidental income has now been removed from the scope of 'Qualifying Income'.</li> <li>• The definition of ancillary activities has also been amended to mean an activity that is necessary for the performance of the main activity or where it makes a minor contribution to it and is so closely related to the main activity that it should not be regarded as a separate activity.</li> </ul>
3	Updates in the computational aspects of de-minimis requirements	<ul style="list-style-type: none"> <li>• The erstwhile FZ Decisions had provided that de-minimis will be satisfied if non-qualifying revenue derived by QFZP in a tax period is lower of: <ul style="list-style-type: none"> <li>- 5% of the total revenue; or</li> <li>- AED 5 million.</li> </ul> </li> <li>• <b>Non-qualifying revenue is revenue derived from:</b> <ul style="list-style-type: none"> <li>- Excluded Activities</li> <li>- Activities that are not Qualifying Activities when transacting with a non-FZP</li> </ul> </li> <li>• <b>Non-qualifying revenue &amp; total revenue does not include the following:</b> <ul style="list-style-type: none"> <li>- Revenue from immovable property located in FZ that is not commercial property</li> <li>- Revenue from commercial property located in FZ and derived from non-FZP</li> <li>- Revenue attributable to a Domestic Permanent Establishment (PE) or a Foreign PE of QFZP</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Non-qualifying revenue shall <b>also include</b> revenue from another FZP, where such FZP is not the 'beneficial recipient' of the relevant goods or services</li> <li>• <b>Non-qualifying revenue &amp; total revenue shall not include</b> income derived from ownership and exploitation intellectual property except for revenue related to qualifying income earned from QIPs</li> </ul>



S. No.	Aspects	Erstwhile FZ Decisions and PCD on FZ	Updated FZ Decisions
4	Clarifications on maintaining adequate substance and outsourcing in a FZ	<ul style="list-style-type: none"> <li>The erstwhile FZ Decisions provided that a QFZP shall undertake its <b>core income-generating activities (CIGA) in a FZ</b> and, having regard to the level of the activities carried out, -               <ul style="list-style-type: none"> <li>have <b>adequate assets</b></li> <li><b>adequate number of qualified employees</b> and</li> <li>incur an <b>adequate amount of operating expenditures</b></li> </ul> </li> <li><b>Outsourcing:</b> Activities could be outsourced to a related party or a third party <b>in a FZ</b> provided the QFZP <b>has adequate supervision of the outsourced activity.</b></li> </ul>	<ul style="list-style-type: none"> <li>The updated FZ Decisions has now specially added the term 'Designated Zone' in relevant paragraphs –               <ul style="list-style-type: none"> <li>Thus, now a QFZP shall undertake its CIGA in a <b>FZ or a DZ, depending on where such activities are required to be conducted.</b></li> <li>Further, the QFZP, having regard to the level of the activities carried out, is required to have adequate assets and adequate number of qualified full-time <i>(the term "full-time" has been added)</i> employees in a FZ or a DZ, depending on where such activities are required to be conducted and also incur an adequate amount of operating expenditures.</li> </ul> </li> <li><b>Outsourcing criteria has been amended to –</b> <ul style="list-style-type: none"> <li>CIGA can be outsourced to a <b>FZ or a DZ</b> depending on where such activities are required to be conducted, subject to adequate supervision</li> <li>CIGA in relation to QIPs can be outsourced to any Person in the UAE (FZP or non-FZP) and any third-party outside UAE, subject to adequate supervision</li> </ul> </li> <li><b>Meaning of CIGA added</b> - CIGA may vary activity wise but mainly consist of those significant functions that drive the business value for each activity carried out by a Qualifying Free Zone Person and are not exclusively or mostly support activities.</li> </ul>

S. No.	Aspects	Erstwhile FZ Decisions and PCD on FZ	Updated FZ Decisions
5	Updated List of Qualifying Activities updated, and scope of activities described	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 regulatory oversight f) Fund management services that are subject to regulatory oversight g) Wealth and investment management services that are subject to regulatory oversight h) Headquarter services to Related Parties. i) Treasury and financing services to Related Parties. j) Financing and leasing of Aircraft 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 above	<ul style="list-style-type: none"> <li>Trading of <b>Qualifying Commodities</b> (defined below) has been added to the list and only covers physical trading activities of Qualifying Commodities and associated derivative trading used to hedge against risks involved in such activities               <ul style="list-style-type: none"> <li>Qualifying Commodities has been defined to include metals, minerals, energy and agriculture commodities <b>that are traded on a recognized Commodities Exchange Market (UAE or foreign) in raw form</b></li> </ul> </li> <li>The activity of 'Holding of shares and securities' has been amended to 'Holding of shares and securities for <b>Investment purposes.</b>' It has been clarified that shares and other securities are deemed to be held for investment purposes when held for an uninterrupted period of at least 12 months</li> <li>The description of distribution activity in the list of "Qualifying Activities" has been reduced to 'Distribution of goods or materials in or from a Designated Zone.' Consequently, pursuant to the PCD on FZ, a description for such activity has been provided which includes ".....the buying and selling of goods, materials, component parts or any other items that are tangible or movable and may include the <i>importation, storage, inventory management, handling, transportation and exportation of those goods or materials.....</i>"</li> <li>Pursuant to the PCD of FZ, descriptions of other Qualifying Activities have also been added.</li> </ul>
6	Updated list of Excluded Activities	a) Transactions with natural persons b) Regulated financial services activities (Banking, Insurance, Finance & leasing activities other than those covered in Qualifying Activities) c) <i>Ownership or exploitation of intellectual property assets</i> d) Ownership or exploitation of immovable property, other than transactions with FZP in relation to commercial property located in FZ e) Activities ancillary to the above-mentioned activities	<ul style="list-style-type: none"> <li>Ownership or exploitation of intellectual property assets has been removed from the list of Excluded Activities</li> </ul>

## B. Methodology for computing Qualifying Income derived from QIP

**Qualifying Income = [(Qualifying Expenditures + Up-lift expenditures)\*Overall Income] / Overall Expenditures**

- The above items have been defined as under:
  - **'Qualifying Intellectual Property'** is defined to mean Patents, Copyrighted Software, and any right functionally equivalent to a Patent that is both legally protected and subject to a similar approval and registration process to a Patent, such as utility models, intellectual property assets that grant protection to plants and genetic material, orphan drug designations, and extensions of Patent protection, but not including any marketing related intellectual property assets, such as trademarks.
  - **'Qualifying Expenditures'** means expenditures incurred to fund R&D activities, either conducted by the QFZP or the outsourced entity, directly connected with the creation, invention, or significant development of the QIP.
  - **'Overall Expenditures'** = Qualifying Expenditure + Acquisition costs of the QIP.
  - **'Overall Income'** means royalties, or any other income derived from QIP as determined according to the provisions of the Corporate Tax Law, including embedded Intellectual Property income derived from the sale of products and the use of processes directly related to the QIP as determined under the arm's length principle.
  - **'Uplift Expenditures'** means the Qualifying Expenditure increased by 30%, subject to the overall capping of up to Overall Expenditures.

## C. Andersen Takeaway

- The methodology provided for computing the qualifying income from 'QIP' seems to be targeted towards entities that carry out research and development, either by themselves or by outsourcing it.
- The inclusion of trading in Qualifying Commodities to the list of Qualifying Activities is a welcome addition. However, considering the requirement for the eligible commodities to be traded on a recognized exchange, businesses will be required to analyse whether their activities fall under the scope or not.
- With the updated requirements of substance, it will now be critical for eligible distributors to maintain adequate substance in a DZ including full-time employees.
- While descriptions and definition for various 'Qualifying Activities' has been added to the new implementing decisions, though, businesses will require further clarity on certain remaining open aspects and whether they fall under the scope of the relevant 'Qualifying Activity'.

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