

UAE CT: “Free Zone Persons” Guide

Key Takeaways



June 2024



“Free Zone Persons” Guide



The Federal Tax Authority (FTA) has released a Corporate Tax (CT) Guide on Free Zone (FZ) Persons, one of the most important and complex areas of the new regime. This Guide serves as a significant resource, providing clarifications and additional insights on various important topics in relation to FZ Persons.

Key highlights

Scope of the Guide

- The Guide seeks to cover all matters related to taxation of FZ Persons, including clarifications with respect to the following:
 1. General CT rules for FZ Persons,
 2. Specific requirements to be a Qualifying FZ Persons (QFZP),
 3. CT Calculation for FZ Person,
 4. Adequate substance,
 5. Foreign PE or domestic PE of QFZP,
 6. Immovable and Intellectual Properties of FZ Person,
 7. Qualifying Activities (QA)
 8. Compliance obligations.
- The Guide also includes multiple examples (including industry specific examples).

1. General CT rules for FZ Persons

- The guide confirms that FZ Person refers to a juridical person, i.e. incorporated, established, or otherwise registered in a FZ, including a branch of a Non-Resident Person or a UAE juridical person that is registered in a FZ.
- Non-juridical persons (e.g. unincorporated partnerships or natural persons) cannot be FZ Persons. Also, a juridical person incorporated or established outside of a FZ cannot be considered as a FZ Person solely because it is being effectively managed and controlled in a FZ.
- To confirm if they operate in a FZ or Designated Zone (DZ) for CT purposes, taxpayers should check with their respective FZ Authority.
- The guide clarifies that a FZ Person refers to the juridical person as a whole including a Domestic Permanent Establishment (PE) (DPE) or a Foreign PE (FPE), e.g. a head office in FZ and a branch in mainland (i.e. DPE), or a head office abroad (i.e. FPE) and its FZ registered branch. Also, a UAE juridical person with a FZ branch will be a FZ Person with the UAE juridical person becoming a DPE.
- In such scenarios above, the potential QFZP 0% CT rate applies only to the FZ Person's FZ Business, while income of the DPE or FPE should be taxed at the standard 9% CT rate. Where a QFZP has business taxed at 9% (e.g. through a DPE or FPE), the standard UAE CT Law rules and reliefs apply, except for the Tax Group regime, transfer of Tax Losses, Business Restructuring Relief or Qualifying Group Relief.
- In addition to complying with Transfer Pricing (TP) documentation requirements for transactions with Related Parties (RPs) and Connected Persons, where a FZ Person has income that is subject to the 9% CT rate, it should be able to demonstrate how the profits attributed to its FZ Business reflect an arm's length share of the overall profits based on the functions performed, assets used, and risks assumed. Income allocated to a DPE or FPE does not form part of the non-qualifying Revenue de minimis calculations.





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2. Specific requirements to be QFZP

- A FZ Person will be deemed to be a QFZP unless one of the conditions to be a QFZP is not met, or if the QFZP makes an election to be subject to the standard CT regime. The election can be made before the deadline for filing the CT return for a relevant tax period, and will then apply for that tax period plus the next four tax periods. After that, it would need to make a new election to not be treated as a QFZP.
- For the “Beneficial Recipient” test for FZ to FZ transactions, the goods or services must be for the use by FZ person and not its FPE or DPE. A conduit or intermediary, such as an agent or nominee, will not pass the test. A QFZP is required to consider if the purchaser is the Beneficial Recipient, for example by obtaining a written statement or undertaking.
- De minimis requirements are covered in detail, including the segregation of revenues into multiple components to calculate ‘total revenue’ and ‘non-qualifying revenue’. The income of CT exempt persons, such as Extractive Businesses, is excluded from the tested revenue calculations.
- A newly established FZ Person that does not earn any QI 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 mln) is earned, the QFZP status will be tainted for the current year and next 4 years.
- For example, if QFZP status is lost for 2024, then 2025-2028 years are also lost. Then as of 1 January 2029, a FZ Person would test again whether it qualifies as QFZP for 2029. If not, then the QFZP status would be lost again for 2029-2033 till 1 January 2034.

3. Calculating CT for FZ Persons

- This section provide examples and guidance on how to calculate the tax due by a FZ Person and the allocation of income and expenses between the QFZP and standard CT regimes. QFZP needs to (i) separate the revenues in its financial statements (FS) into QI and Taxable Income components, (ii) allocate direct and indirect expenses in its FS against those components, and (iii) apply CT Law tax adjustments to arrive at Taxable Income for 9% CT rate.
- The Guide suggests a 2-step approach to attribute profit between FZ Business and DPE/FPE. Step 1 is a functional analysis to identify the functions performed by the FZ Business vs. DPE/FPE including the assets used and the risks assumed by each. Step 2 is to determine the compensation relating to the arrangements between the FZ Business and DPE/FPE.
- Where expenses cannot be directly attributable to the qualifying income, allocation of the expenses is needed on an arm's length basis. A pro rata expense allocation based on revenue can be considered a reasonable allocation.
- If a QFZP incurs Tax losses on the taxable income component, those tax losses can be carried forward and offset against the QFZP's taxable income in subsequent tax years, except against income from intellectual property (which can only be offset by losses from such intellectual property).

4. Adequate substance of QFZP

- The Guide provides more clarity on FZ substance matters, with examples.
- Core income-generating activities (CIGA) refer to the essential and value-adding activities that a FZ Person performs to generate its FZ Business revenue. CIGA are required for each QA, or the FZ Person cannot be a QFZP. The QI should reflect the level of CIGA consistent with the arm's length principle. A QFZP may perform non-core activities, which do not directly drive sales or are routine in nature, outside a FZ.
- Adequate substance will depend on the nature and size of each business. The key is that the substance should be enough to perform CIGA. For example, a holding company could have no employees, but as long as its Board of Directors performs key decision-making in a FZ, the substance could be adequate.
- Adequate number of full-time qualified employees is required to perform each QA. The same employee, if involved in more than one CIGA, can be counted only for one of them and cannot be double counted.





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4. Adequate substance of QFZP (cont'd)

- CIGA employees shall operate from within a FZ, but they may spend time outside the FZ if required. For example, headquarter services may require regular time spent at subsidiaries. CIGA performed through a DPE will be ignored for substance test as it focuses on a separate FZ Person. “Rubber stamping” or mere execution in a FZ of key decisions taken outside the FZ will not qualify.
- For outsourced CIGA, a QFZP must have mechanisms and means in place to observe, oversee, assess, instruct, and provide guidance over the deliverables in terms of quality, quantity, and timelines. There must be contractual arrangements setting out how supervision will be performed, confirmed by the actual conduct of the parties.

5. Foreign PE or domestic PE of QFZP

- FPE/DPE should be treated as if it were a separate and independent non-FZ Person using the arm's length principle. FPE/DPE can be created due to a fixed place of business outside a FZ or conducting business through a dependent agent outside a FZ. The PE rules from the CT Law shall be applied.
- For the fixed place PE test, three elements are tested: (i) the place must be identifiable, (ii) it must be fixed or permanent in nature, (iii) the business of QFZP must be wholly or partly conducted through this place. Owning a property outside the FZ to derive lease income may not create a PE, however such income will impact the de minimis test for QFZP. Also activities of preparatory and auxiliary activities do not lead to a PE.
- For the dependent agent PE test, three elements are tested: (i) authority to conclude or negotiate contracts on behalf of the QFZP, (ii) habitual exercise of the authority, (iii) independence of the person.

6. Immovable and Intellectual Properties of FZ Persons

Immovable Property

- QI can only arise from transactions with a FZ Person who is Beneficial Recipient and only in respect of commercial property inside FZ. Other FZ immovable property transactions are taxable at 9% but disregarded for the non-qualifying income de minimis test.
- Income from mixed-use property in a FZ is to be allocated to QI and non-QI. Direct allocation of revenue is the preferred method and where it is not possible, then allocation based on specific market conditions and property characteristics or floor space could be applied.
- Income from immovable property outside a FZ will be considered for the non-qualifying income de minimis test, unless it is attributable to a FPE/DPE.

Intellectual Property

- To benefit from Qualifying Intellectual Property (QIP) rules, a QFZP must set up a system to track income and expenses associated with QIP to show that QI and Qualifying Expenditures are linked. Before setting-up this system, the QFZP needs to consider whether QIP should be tracked on an asset, product, and/or product family basis because this affects how R&D should be tracked. There are several examples of tracking systems in the Guide. If a QFZP does not have an adequate tracking system, it will be unable to apply the 0% CT rate to income from its QIP.
- The Guide provides methodologies to account for “Qualifying Expenditures” and “Overall Expenditures” by specifying the following:
 - The nexus approach comprises a cumulative ratio of Qualifying Expenditures and Overall Expenditures over the life (incl. expenditure incurred prior to enforcement of the UAE CT law) of the QIP asset. Qualifying Expenditures will include expenditures at the time they are incurred, irrespective of the accounting or tax treatment.
 - A QFZP that was established before the CT law took effect may, for the first three tax periods following the introduction of the rules, apply a ratio where Qualifying Expenditures and Overall Expenditures are calculated based on a three-year rolling average. The QFZP would then transition to using a cumulative ratio for the fourth and subsequent tax periods.





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Intellectual Property (cont'd)

- Typically R&D costs could include salary and wages, direct costs, overhead costs directly associated with R&D facilities, and cost of supplies. Interest payments, building costs, acquisition costs, or any costs that cannot be directly linked to a specific QIP asset are excluded. Where R&D activities are outsourced to any person in the UAE (or an unrelated person outside the UAE), the amount of Qualifying Expenditures should be determined on the same basis as if they were undertaken by the QFZP itself. Expenses for unsuccessful R&D would not be considered in the formula when calculating QI.
- The Guide requires the QFZP to maintain all records, books and documents that demonstrates the nexus between Qualifying Expenditures and QI from each QIP asset/product. The QFZP must maintain documentation showing the complexity of its intellectual property business model and providing justification for using the approach in terms of tracking the income and expenses related to QIP (e.g. product-based tracking approach instead of assets, etc).

7. Qualifying Activities

Manufacturing of goods or materials

- The Guide clarifies that various types of manufacturing activities across different sectors and industries could be considered under this QA, including the manufacture of goods or materials on behalf of another person (i.e. contract or toll manufacturing), and the manufacture of goods or materials at own risk (i.e. full-fledged manufacturing).
- This QA includes all activities from the beginning of a product (i.e. conception, business plan, capital investment, R&D, raw materials) to the end stages of production (i.e. finished product). Manufacturing refers not only to producing new goods but also to improving or assembling pre-existing components.
- Software embedded in hardware (i.e. it is inherently part of the hardware) generally would be considered as goods for this QA.
- Main activities may include production planning, actual production, and quality control. Ancillary activities may include post-sale service (installation, warranty, maintenance, upgrade) and customer support, but distinctly exclude repairs. Whether the other functions (for example, generating sales, packing and loading, delivery) should be considered to be part of this QA would depend on whether those functions could be considered ancillary, which will depend on the specific facts and circumstances. Goods that are manufactured in the UAE do not need to pass through a DZ, however, the distribution activity is required to be conducted in or from a DZ in order to be a QA.

Processing of goods or materials

- Processing is a wider concept than manufacturing and may occur where an item undergoes a process but remains essentially the same thing and no new product is created. While processing is different from manufacturing, the two are interconnected steps in many industries.
- Main activities may include planning, actual processing (repetitive or continuous action applied to goods or materials, involving activities like assembly, fabrication, machining, chemical reactions, printing, or packaging depending on the industry), and quality control. Ancillary activities may include post-sale services and customer support.

Trading of Qualifying Commodities

- The Qualifying Commodity needs to be in a form that is traded on a Recognised Commodities Exchange Market (Exchange). Metals, minerals, energy and agriculture commodities that are traded on a Recognised Commodities Exchange Market will be deemed to be in raw form when they meet the conditions to be traded on the said exchange.
- The actual trade of the Qualifying Commodity for QA purposes does not need to be performed through an exchange and may occur off-market.





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Trading of Qualifying Commodities (cont'd)

- The meaning of raw form typically refers to commodities that are in their natural and unprocessed state, and no value has been added to the commodity once it was grown, extracted, or mined. However, while many commodities are traded in their raw form, some degree of processing may sometimes be involved to meet the trading standards or specifications required to even be traded on an Exchange. This processing typically aims to ensure uniformity and quality control, which makes large-scale trading possible. Commodities that have undergone minimal processing (such as cleaning, sorting, grading, and minor refining) are still considered to be in their raw form.
- The HSN code can serve as an indicator in verifying if a commodity still maintains its raw form. A mere alteration in HSN code due to some level of processing does not conclusively determine whether that commodity has lost its raw form for the purposes of determining whether it is a Qualifying Commodity.
- The main activity for this QA is buying and selling. Activities of warehousing and delivery can be considered as ancillary.

Holding of shares and other securities for investment purposes

- This QA includes holding ordinary shares, preferred shares, redeemable shares, membership and partners interest, options, warrants, other types of securities, capital contributions and rights, etc. Cryptocurrency was also added in the Guide as an investment instrument for holding.
- In addition to buying and selling of securities, this QA could include activities such as investment planning and portfolio management. QI may include dividends, capital gains, bond interest, and even financial recovery from shares, indemnity claims under M&A deals, securitisation of receivables from financial assets (non-financial assets do not qualify) etc.
- Expanding on the 12 month holding period requirement, the Guide clarifies that also the intention to hold for at least 12 uninterrupted months (and the intention can be demonstrated) would qualify.
- The main activity for this QA is buying and selling securities. The Guide does not provide any examples of activities that could be ancillary to this QA.

Ownership, management and operations of Ships

- Ships include tugboats, barges, etc. that are used for marine operation, or to transport goods or passengers from vessels in international waters to UAE domestic waters, or to maneuver other types of Ships (for example, container ships, passenger ferries, etc.).
- Ships used in providing offshore oilfield and maritime services, involving such operations as oil drilling, seismic surveys, and related services typically associated with oilfield support and offshore vessels, are within the said QA.
- International transportation means the movement (of goods or persons) beyond the territorial waters of the UAE. Transportation between two ports in the UAE would be considered to be international transportation provided it is an integral part of transportation involving a broader itinerary that includes ports outside of the UAE.
- The Guide defines what activities are included in “Ownership”, “Management”, and “Operation” of Ships.
- The main activities for this QA is ownership, management and operation of ships. Activities of shipbroking and organising and overseeing voyages can be considered as ancillary.

Reinsurance services

- Main activities for this QA may include underwriting premiums, salvage and subrogation recoveries, claim handling or management and loss adjusting and claims management.
- Ancillary activities may include investing activities (investing the premiums received from insurers in bonds, stocks, real estate, and other financial instruments that provide a return until they need to pay out claims), actuarial services and risk management (e.g. risk consulting services and special claim handling and settlement services).





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Fund management services

- Fund management primarily includes managing a specific portfolio of investments on behalf of third-party investors. This could be a mutual fund, a hedge fund, or a pension fund.
- Main activities for this QA may include investment planning and strategy, investment diversification, asset allocation, fund management, and performance monitoring.
- Activities such as financial advisory, training and education, financial planning and technological support that complement the above activities could be regarded as ancillary.

Wealth and investment management services

- The Guide clarifies that wealth and investment management is a holistic service that differs from fund management because it extends beyond just investing and encompasses all parts of a person's financial life.
- Services such as retirement planning, estate planning, tax planning, budgeting, portfolio management, financial planning and asset allocation have been listed as the main activities for this QA.
- Activities such as risk management, market research, investment analysis and family governance that complement the above activities could be regarded as ancillary.

Headquarter services to RPs

- The reference to RPs for the purposes of this QA is limited to majority owned/controlled juridical persons and branches, including FPE/DPE of a FZ Person. The FZ Person can take the responsibility for the overall success of the group, or an important aspect of the group's performance, and ensure corporate governance. This has been further clarified to include: the provision of strategic services, senior management, the assumption or control of material risk for activities carried out by group companies, or substantive advice in relation to the assumption or control of such risks.
- The above requirement has been reflected in the illustrative list of main activities for this QA: taking relevant management/strategic decisions, incurring operating expenditures on behalf of group entities, coordinating group activities, financial management, central procurement services, human resource management, technical support, legal and compliance services, and intellectual property management. Training and development activities for the employees of RPs are ancillary.
- Procurement and sale of goods to RPs may not qualify for this QA based on an example in the Guide.

Treasury and financing services to RPs

- The reference to RPs for the purposes of this QA is limited to majority owned/controlled juridical persons and branches, including DPE of FZ Person and self-investment by FZ Person. Self-investment of funds (for instance bank deposits) would also fall within this QA.
- In addition to providing financing (e.g. shareholder loans) to RPs, the Guide mentions the provision of cash management, risk management, and investment management services to RPs also within the ambit of this QA. Cash pooling also qualifies.

Financing and leasing of Aircraft

- The Guide provides a broad coverage of financing and leasing of Aircraft, Aircraft engines or rotatable components including activities relating to agreeing funding terms, acquisition, setting the leasing terms and funding terms, lease management etc. Sub-leasing of Aircraft will fall within the scope of this activity.
- The activities such as credit analysis, portfolio management of leasing contracts and financing agreements, disposal of the Aircrafts / components, and asset management are listed as ancillary. Revenue from sale of Aircraft after its use in leasing business would qualify as QI.
- Brokerage services will not qualify for this QA.





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Distribution of goods and or materials in or from a DZ

- Distribution involves holding title to products, and excludes FZ Persons acting solely as agents.
- A FZ Person engaged in distribution must conduct due diligence, such as 'know your client' procedures, to verify that their customer is not the end user. The end user could be a person that the goods are ultimately intended for, after it has been passed through any intermediate stages of distribution, production, or resale. In other words, the end user is the person who eventually uses the product for its intended purpose, whether that may be personal, commercial, or industrial.
- The requirement for goods to enter a DZ applies only to the distribution of foreign goods to customers in the UAE outside of the DZ. High sea sales with CIGA in DZ are QA. UAE made/located goods may be shipped directly to a UAE/foreign distributor/retailer without passing through a DZ.
- Various activities constituting main activities for this QA are outlined, including the purchase and resale of goods/materials, warehousing, transportation, delivery, logistics, inventory management, order processing, and packaging/repackaging. Ancillary activities such as marketing and advertising, quality control and inspection, and customer support services are listed.
- This QA excludes intangible products and services like licenses, software, and financial products or services. However, if any goods have embedded software or firmware, income for which cannot be separately identifiable, this would not be excluded.

Logistics services

- Logistics services encompass the storage and transportation of goods or materials on behalf of another party without taking title to the goods. Qualifying activities include transporting goods, warehousing, inventory management, declaration and documentation for customs, freight forwarding, order fulfillment, and packing. Ancillary activities may include supply chain management, customs brokerage, and customer service, provided they complement the main logistics activities.
- Where most logistics services are conducted within a FZ for customers within the UAE or abroad, the last mile delivery services outside the FZ still qualify as part of the QA.

Main vs ancillary activities

- The examples of ancillary activities provided in the Guide are illustrative and any activity must be evaluated in the context of the nature of the specific QA. Ancillary activities must naturally and integrally complement the main business conducted by the FZ Person. If a listed ancillary activity is performed by the FZ Person without the execution of the main activity, it will not be treated as a QA.
- A QFZP may generate surplus funds that are not essential for the immediate needs of its business but may be required for identified future working capital requirements. In that case, the QFZP may decide to retain the funds for future use, rather than returning the surplus to investors. The investment of surplus funds is not considered as an ancillary activity and therefore would need to be a QA in its own right, or any income earned would be non-qualifying revenue.

Excluded activities (EA)

- Revenue from EA is to be treated as non-qualifying revenue while computing the de minimis requirements, unless the revenue is attributable to a FZ Person's FPE/DPE or pertains to immovable property in a FZ that does not generate QI.
- All transactions with individuals are considered EA, with the exception of transactions in relation to: (i) ownership, administration, and operation of ships, (ii) regulated fund management, wealth and investment management services, and (iii) aircraft financing and leasing.
- “Banking activities” are the specified regulated financial activities. These do not encompass fund management services, wealth and investment management services, or treasury and financing services provided to RPs if they form a distinct and separate business conducted by a FZ Person.
- “Insurance activities” do not encompass reinsurance activities. Reinsurance activities and captive insurance falling under the QA of “reinsurance services” or “headquarter services to RPs” are expressly excluded from the purview of this EA.





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Excluded Activities (EA) (cont'd)

- “Financing and leasing activities” are regulated ones and refer to providing credit or financing for any form of compensation (including digital and cryptocurrency), as well as leasing, renting, or otherwise authorizing the use of an asset in exchange for rent or other consideration under a finance lease, operating lease, or similar arrangement. They do not include financing and leasing of ships, financing services to RPs and financing and leasing of aircraft.
- “The ownership or exploitation of Immovable Property”, other than Commercial Property located in a FZ where the transaction in respect of such Commercial Property is conducted with other FZ Persons, is EA.

8. Compliance obligations

- Taxable FZ Persons, including QFZPs, must register for UAE CT (if not CT exempted), and then file CT return and pay CT (if any due) within 9 months after end of the relevant tax period.
- They must keep all necessary records and documents for CT purposes for 7 years.
- A non-resident juridical person with a branch in a FZ that derives only State Sourced Income and does not have a PE in the UAE is not required to register for UAE CT purposes.
- A QFZP is not required to prepare separate financial statements for its QI and its other income and is also not required to prepare separate audited financial statements for any branches that it may have as long as it has sufficient documentation to determine the QI.

Key takeaways

- The Guide provides further much needed guidance on the interpretation of QAs, and taxpayers should evaluate these in relation to their own specific activities. However, some ambiguities still remain.
- A FZ Person that does not earn any QI in a Tax Period because it has not yet started to derive Revenue (i.e. start ups) will not be disqualified from being a QFZP on the basis that no non qualifying income (exceeding de minimis rule) is earned.
- Compliance with TP requirements is one of the key criteria for maintaining QFZP status. It is also important to assess adequate substance from TP perspective. Also, the Guide suggests a 2-step approach to attribute profit between FZ Business and DPE/FPE: Step 1 is a functional analysis including the assets used and the risks assumed. Step 2 is to determine the compensation.
- Adequate substance will depend on the nature and size of each business. The key is that the substance should be enough to perform CIGA relative to the level of QI. CIGA employees shall operate from within a FZ, but they may spend time outside the FZ if required. CIGA performed through a DPE will be ignored for substance test.
- Ancillary activities must naturally and integrally complement the main business conducted by the FZ Person. If a listed ancillary activity is performed by the FZ Person without the execution of the main activity, it will not be treated as a QA.

Next steps

The Guide provides guidance and clarity on FZ Persons. Careful consideration and application of these Guidelines are necessary for taxpayers.

For further assistance, you can reach us at CT.UAE@pwc.com.





Thank you



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