UAE Supreme Court Insight on Free-Zone Corporate Tax Exemptions

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The United Arab Emirates (UAE) has many free zones that attract businesses with tax benefits among other incentives. For example, free zones in the UAE typically offer a zero percent corporate tax rate for a certain number of years, often extendable. However, with the introduction of a new corporate tax regime in the UAE, there have been questions about how federal tax laws interact with these domestic exemptions.

A recent judgment from the Federal Supreme Court issued in October 2023 provides clarity on this matter, setting a precedent for how tax laws are applied to entities operating in free zones. This article examines the judgment, explores the exemption provisions for free zone entities under the UAE corporate tax law, and discusses the implications of the judgment.

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The Federal Supreme Court Judgment

The Federal Supreme Court of the UAE recently issued a judgment in October 2023, clarifying the relationship between federal tax laws and domestic emirate-specific tax laws, particularly concerning tax exemptions.

In this case, the Federal Primary Court and the Federal

Appeals Court had found that domestic tax laws have no impact on federal tax legislation. The Supreme Court on the other hand took a different reasoning approach.

The Supreme Court stated: “The local law does not restrict or specify the federal law issued by the federal authorities; rather, they operate within a framework of legislative integration and synergy. The petitioner is considered subject to tax, as what it practices in the activity in question … aims for profit as a whole. The [tax] exemption of the petitioner does not change the foregoing.”

The petitioner had approached the Supreme Court after being subject to a number of ministerial decrees in its respective emirate that provided exemptions from any form of tax. The petitioner sought to overturn the findings of the lower federal courts.

The Federal Primary Court had stated: “That the law establishing the Federal Tax Authority in its Article 4 outlined the authority’s jurisdiction over the management, collection, and enforcement of federal taxes and related fines…The local laws regarding exemption from tax and local fees were only concerned with the concerned emirate and have no impact on the application of the federal tax law.”

Similarly, the Federal Appeals Court had noted: “The exemptions issued under local legislations have no impact on the application of the tax imposed under federal tax legislations.”

The lower federal courts focused on whether the exemptions granted to the petitioner in its respective emirate were reflected in the federal tax legislation or not. The lower federal courts reasoned that domestic emirate-specific tax exemptions operate only to the benefit of the taxpayer within the applicable emirate but not on a federal level.

However, the Supreme Court highlighted that the focus should

be on whether an entity is engaged in profit-making activities, rather than where it operates, and whether the federal tax legislation has adopted the emirate-specific tax exemptions. Through this judgment, the Supreme Court confirmed that domestic tax laws do in fact apply but must be applied in "integration and synergy" with federal tax laws, marking a departure from the reasoning of the lower federal courts and providing reassurance for free zone entities.

Exemption Provisions for Free Zone Entities

The new corporate tax law in the UAE, introduced in 2022, outlined the tax obligations for all entities, including those in free zones. To be considered for tax exemptions, a free zone entity needs to meet several conditions. These conditions include maintaining a substantial presence in the UAE, earning qualifying income, and following specific auditing and pricing regulations. If a free zone entity meets all the required conditions, it is termed a "Qualifying Free Zone Person" (QFZP) and can enjoy tax exemptions. The law aims to ensure that entities are compliant with international tax standards while also providing a clear framework for tax obligations and exemptions.

Implications of the Supreme Court Judgment

The judgment of the Supreme Court is crucial as it identifies that a profit-generating entity falls within the federal tax regime despite any emirate-specific tax exemptions. This confirms that profit-making entities in free zones are subject to federal tax laws, just like other entities outside free zones. The judgment helps in understanding how federal and local tax laws interact, ensuring that businesses in free zones are also contributing to the country's tax revenue when they engage in profit-making activities. It aligns the tax treatment of free zone entities with the broader tax framework of the UAE, promoting fairness and compliance with the new corporate tax regime.

It is important to consider notwithstanding that the Supreme Court acknowledges the existence and validity of domestic tax exemptions, such as those provided in free zones, without setting them aside. Instead, the Supreme Court emphasizes a prerequisite for domestic emirate exemptions to operate in "integration and synergy" with federal tax laws. This denotes a principle of harmonization between federal and local tax frameworks, underscoring that the local exemptions are recognized as long as they are in alignment with the overarching federal tax laws.

Takeaway

In conclusion, this novel judgment by the Federal Supreme Court, along with the new corporate tax law, provides a clear understanding of the tax obligations for entities operating in free zones. It ensures that all entities, regardless of their location, are subject to the same tax laws if they are engaged in profit-making activities. This creates a level playing field for all businesses, contributing to a transparent and fair business environment in the UAE.

The principle set by the federal courts is reassuring for free zone entities as it does not dismiss domestic tax exemptions outright. It provides a structured approach where both federal tax obligations and local tax exemptions coexist, given they are operating in harmony. This balanced standpoint from the Federal Supreme Court affirms a level of reassurance to free zone entities, emphasizing a cooperative framework between federal and local tax legislations, which is crucial for the financial and operational stability of entities operating in free zones, and establishes grounds for free zone entities to apply and utilize free zone tax benefits.

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