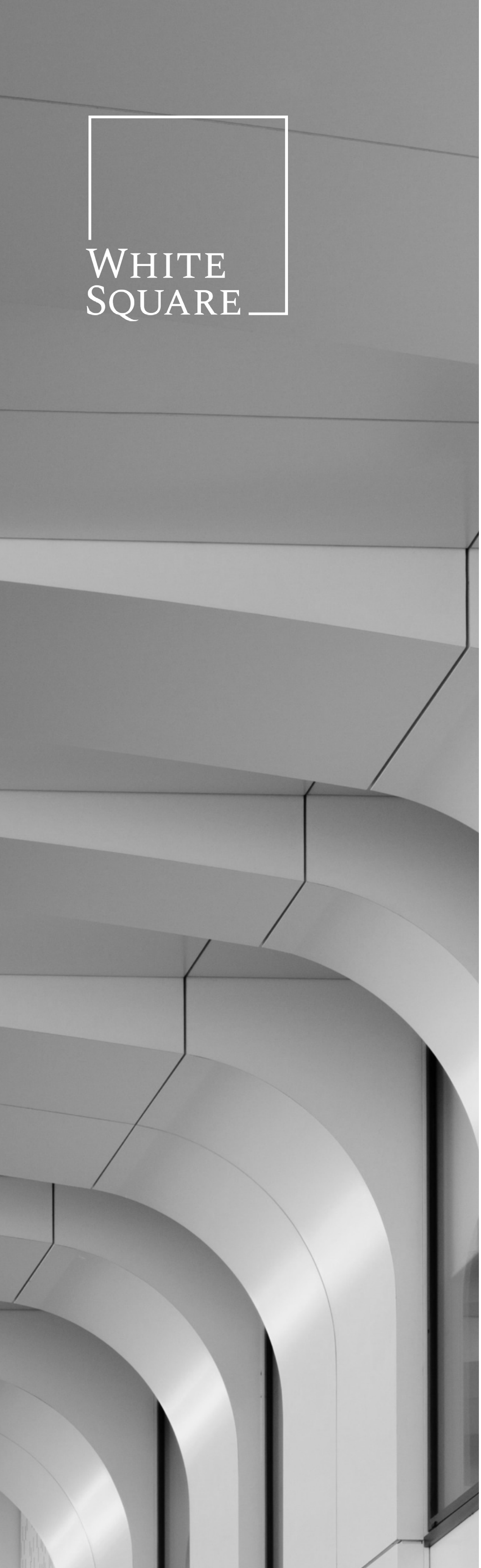

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UAE FEDERAL TAX AUTORITY (FTA) HAS BEGUN AUDITING COMPLIANCE WITH THE CRITERIA FOR APPLYING THE 0% TAX RATE: WHAT YOU NEED TO KNOW AND HOW TO PREPARE

14 August 2026

The first filing cycle for corporate tax returns in the UAE has concluded. The submitted returns have been audited by the Federal Tax Authority (“**FTA**”).

An inevitable consequence of the audit of the first corporate tax returns has been a wave of inquiries from the FTA to taxpayers. The FTA’s inquiries have focused primarily on companies incorporated in free zones that claimed the preferential 0% tax rate on their returns.

It should be noted that the 0% tax rate is not available to all companies established in free zones, but only to those that meet the requirements for obtaining Qualifying Free Zone Person (“**QFZP**”) status.

As a general rule, QFZP status is presumed for companies in free zones; however, they may lose their right to apply the 0% tax rate if the FTA identifies non-compliance with at least one of the requirements for QFZP status.

The current wave of inquiries is specifically aimed at verifying taxpayers’ compliance with the conditions for obtaining QFZP status.

This material is based on information from public sources and is for reference purposes only. It does not constitute advice or a legal opinion. If you have any questions regarding this alert, please contact us at: info@whitesquarepartners.com.

1. Requirements for Applying the 0% Tax Rate: QFZP Status

To be considered a QFZP and be eligible for the 0% tax rate, a company registered in a free zone must:

1) maintain an adequate level of substance in the free zone, i.e.:

- carry out core income-generating activity ("**CIGA**") within the free zone; and
- have an office, assets, employees, and expenses in the free zone that are sufficient to carry out CIGA.

2) generate qualifying income, specifically:

- from activities included in the closed list **("Qualifying Activities"),** such as:
  - holding of shares and other securities;
  - granting loans to related parties;
  - trading of certain commodities;
  - distribution of goods;
  - activities that are ancillary to the Qualifying Activities (i.e., activities that serve no independent function and are necessary solely for the conduct of the main Qualifying Activity); or
- transactions with other companies established in free zones;
- income from IP under certain conditions (hereinafter collectively referred to as **"Qualifying Income"**);

3) not have elected to be subject to the standard 9% corporate tax rate;

4) comply with the arm's length principle when conducting transactions with related parties and connected persons and prepare transfer pricing documentation;

5) prepare audited financial statements; and

6) ensure that the portion of revenue derived from income that is not attributable to Qualifying Income ("**Non-Qualifying Revenue**") does not exceed the lesser of:

- 5% of the company's total revenue; or
- AED 5 million ("**de minimis requirements**").

2. What the FTA Checks in Practice

1) Classification of income and revenue allocation

First and foremost, the FTA scrutinizes whether the company has correctly classified its income as Qualifying Income.

Correct classification requires separate accounting records that allow the company to distinguish among the following categories: Qualifying Income, Non-Qualifying Revenue, and income that is not considered when calculating the de minimis requirements and is always taxed at a rate of 9% ("**Disregarded Income**").

The FTA compares the company's reported classification of income with the types of activities specified in its trade license. The FTA also requests contracts and invoices to determine whether the classification of income actually corresponds to the company's actual activities.

2) Compliance with the de minimis requirements

The FTA pays particular attention to the procedure for calculating thresholds under the de minimis requirements.

For example, the FTA requests documents confirming the status of counterparties (place of registration, information on whether the counterparty is the beneficial recipient of goods or services purchased from the company).

It should be noted that income from transactions with other companies in free zones that are not the beneficial recipients of the goods or services purchased must be included in Non-Qualifying Revenue when calculating the threshold under the de minimis requirements.

A counterparty will not be considered the beneficial recipient of goods or services if it is bound by a contractual or other obligation to provide the purchased goods or services to another party.

Therefore, a company applying for QFZP status must ensure that its counterparties in the free zones are the beneficial recipients of the goods or services. In the absence of proper documentary evidence, the FTA may classify income from transactions with such counterparties as Non-Qualifying Revenue.

If Non-Qualifying Revenue exceeds the threshold of 5% of the total revenue or AED 5 million, the company will lose its right to apply the 0% tax rate.

3) Maintaining adequate substance

The FTA assesses the adequacy of the substance in the free zone based on payroll records, office lease agreements, utility bills, visa documentation, minutes of board of directors meetings, and evidence that management decisions are made within the free zone.

The FTA's inquiries focus on verifying that CIGA is carried out in the free zone by employees who possess the necessary qualifications and authority.

Furthermore, the scale of CIGA carried out in the free zone must correspond to the scale of the company's operations and its level of income.

Outsourcing of CIGA is permitted only to another free zone company, provided that the company properly supervises the outsourced activities (the FTA may request documents confirming such supervision, such as technical specifications, contractor reports, etc.).

4) Compliance with the arm's length principle

The company's transactions with related parties are reviewed to ensure that prices are in line with the arm's length principle.

It should be noted that all of the company's transactions with related parties and connected persons must comply with the arm's length principle, regardless of the transaction price.

It is also important to note that the scope of transactions subject to transfer pricing rules in the UAE is significantly broader than, for example, in Russia. Thus, all of the company's transactions with connected persons (beneficial owners, regardless of their ownership stake in the company, or directors) must also be conducted on an arm's length basis..

The FTA pays particular attention to the cost of intra-group services, the amount of royalties, and the interest rate on loans.

Companies that cannot demonstrate compliance with the arm's length principle for transactions with related parties and connected persons risk not only having their tax base adjusted, which would result in an increase of their taxable income, but also losing their QFZP status and the right to apply the 0% tax rate.

5) Audited Financial Statements

The FTA verifies whether the company submitted audited financial statements along with its tax return.

The auditor's report, notes to the financial statements, and any qualifications or paragraphs drawing attention to material circumstances are analyzed.

Since, as a general rule, in the absence of specific regulations, a company's profit is determined in accordance with applicable accounting standards, the FTA pays particular attention to “creative” accounting as well as qualifications in the auditor’s report.

3. Conclusions

The requirements for companies in the free zone to qualify for QFZP status cannot be considered merely formal.

The results of the audit of the first corporate tax returns and the subsequent wave of inquiries from the FTA make it clear that the FTA will closely monitor taxpayers’ compliance with the conditions for QFZP status and the application of the 0% tax rate.

In doing so, the FTA will assess the extent to which a company’s business model and level of substance comply with the conditions of the preferential tax regime.

We recommend that all companies in free zones that apply the 0% corporate tax rate prepare and maintain defense files confirming:

- the correct classification of income when categorizing it as Qualifying Income and when calculating the threshold under the de minimis requirements;
- the presence of an office in the free zone, a sufficient number of qualified employees with appropriate authority who carry out CIGA;
- compliance with the arm’s length principle in transactions with related parties and connected persons.

MOST COMMON MISTAKES IN APPLYING QFZP STATUS

Conditions for meeting QFZP requirements and applying the 0% rate	Common mistakes
1. Adequate level of substance in the free zone	▪ Hiring employees not involved in CIGA: accountants, administrators, lawyers, and other administrative staff
	▪ Outsourcing CIGA functions to a company located outside the free zone
	▪ Outsourcing CIGA functions without proper oversight or without having a sufficient number of in-house employees to exercise oversight
	▪ For holding companies: failure to hold regular board of directors meetings in the free zone
2. Generation of Qualifying Income	▪ The company's business model does not align with Qualifying Activities
	▪ Lack of documentary evidence that counterparties in the free zone are the beneficial recipients of the goods or services
	▪ Incorrect classification and accounting of income that is classified as Non-Qualifying Revenue
	▪ Classifying as Qualifying Income ancillary activities that serve an independent function and cannot be considered ancillary to the main Qualifying Activity
3. Not electing to be subject to the standard 9% corporate tax rate	▪ Electing to be subject to the 9% rate during a period when the company had no revenue or incurred losses. Such a choice will prevent the company from obtaining QFZP status in the current and four subsequent tax periods
4. Complying with the arm's length principle when conducting transactions with related parties and connected persons	▪ Granting interest-free loans to shareholders or other related parties
	▪ Failure to conduct benchmarking (an analysis of whether prices comply with the arm's length principle) for transactions with related parties (especially small transactions)
5. Preparing audited financial statements	▪ Absence of an auditor's report at the time of filing the tax return

Conditions for meeting QFZP requirements and applying the 0% rate	Common mistakes
6. Ensuring compliance with the de minimis requirements	▪ Incorrect calculation of total revenue for threshold determination purposes, that is including Disregarded Income
	▪ Incorrect calculation: treating revenue that should be classified as Non-Qualifying Revenue as Qualifying Income
	▪ Planning business operations based on a threshold of 5% of the total revenue without taking into account the AED 5 million threshold, and vice versa

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