

Distribution for the manufacturing

The facts

The company, registered in Jebel Ali Free Zone (JAFZ), Dubai, is engaged in the distribution of tobacco and other materials used in cigarette manufacturing. The company sells directly to cigarette manufacturing factories. It doesn't sell them to the traders (resellers).

The question

Can the activity of selling tobacco and related materials directly to factories for manufacturing cigarettes qualify for a 0% corporate tax rate?

The summary

After analysis below, we conclude:

- 1) There is no definitive answer; arguments exist for both sides.
- 2) We believe that a 0% Corporate Tax rate can be applied to direct sales to factories. However, the lack of explicit clarification from the Federal Tax Authority (FTA) poses a risk of refusal.
- 3) To mitigate this risk, we recommend either:
 - a) Selling to factories through a distributor, or
 - b) Obtaining explicit clarification from the FTA.

The analysis

1. The FTA in the [Free Zones Persons Guide](#) defined the Designated Zone for Corporate Tax purposes as '*a designated zone according to what is stated in Federal Decree-Law No. 8 of 2017, and which has been included as a Free Zone in accordance with the Corporate Tax Law*'. VAT Law No. 8 of 2017 defines as Designated Zone '*any area specified by a Cabinet Decision ... as a Designated Zone for the purpose of this Decree-Law*'. JAFZ is determined as Designated Zone for the purpose of VAT in the Cabinet Decision No. 59 of 2017 and still remains in the [list](#).

On 30 of May 2024, JAFZA [released information](#) that the JAFZ '*is a geographically designated and defined area in the United Arab Emirates and **is considered a qualified free zone for the purposes of the UAE Corporate Tax Law** ...*'. Consequently, the JAFZ meets the FTA's definition of Designated Zone for both VAT and Corporate Tax.

2. Qualified Distribution defined as a *'Distribution of goods or materials in or from a Designated Zone, includes the buying and selling of goods, materials, component parts or any other items that are tangible or movable and may include the importation, storage, inventory management, handling, transportation and exportation of those goods or materials **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**, provided such activities are conducted in or from a Designated Zone and the goods or materials entering the State are imported through the Designated Zone'*.¹ Thus, it is permissible for the buyer of the purchased goods and materials to *'process or alter such goods or materials or parts thereof for the purposes of sale or resale'*.

Clause 3 of the same article distinguishes between processing and manufacturing:

- a. *Manufacturing of goods or materials includes the **production**, improvement or assembly of products and materials **from raw materials** or components.*
- b. *Processing of goods or materials includes the preparation, treatment, **transformation or conversion** of goods or materials **into another form of good or material** for **commercial or industrial use or sale**.*

From this definition, it can be seen that raw materials are processed into a product within the framework of *'manufacturing'* rather than *'processing'*. This distinction is significant because tobacco leaf is considered raw material. The [Implementing Regulation for the Federal Tobacco Control Act](#) defines tobacco products as *'products wholly or partially consisting of **tobacco leaves as a raw material**, whether whole, coarse-cut or fine-cut, and whether in their natural state, mixed with other materials, or formed into any shape, any form of ground tobacco, and any other composite material that includes tobacco as one of its constituents'*.

3. The FTA recommends using *'conventional business practices'* for understanding the terms from the description of qualified activities.²
4. The International Standard Industrial Classification of All Economic Activities ([ISIC, Rev.4](#)) mixes the concepts of manufacturing and processing. For instance, code 1200 "**Manufacture** of tobacco products" *'includes the **processing** of an agricultural product, tobacco, into a form suitable for final consumption'*. This definition merges the concepts of processing and manufacturing since manufacturing consists of processing.

¹ Ministerial Decision No. [265](#) of 27 October 2023, Article 2, Cl. (3), para (I).

² Free Zone Persons Corporate Tax Guide No. [CTGFZP1](#), Sec. 10.1. It elucidates: *'The scope of each Qualifying Activity should be understood in the context of the meanings set out in Ministerial Decision No. 265 of 2023. In particular, **the scope should also take into account how the relevant term is understood in conventional Business practice** and encompasses all processes that form a natural and integral part of a coherent Business that a Free Zone Person is conducting in relation to that Qualifying Activity'*.

5. Taxable Persons Guide Excise Tax No. [EG01](#) employs the term manufacturing in the context of cigarette production. The term processing is not used by the FTA in this context.
6. Analysis of industry standards, including ISO/TC 126 'Tobacco and tobacco products', shows that the activity of making cigarettes from tobacco is considered cigarette manufacturing. The UAE [Federal Law No. \(15\) of 2009](#) on combating Tobacco also uses the term manufacturing in relation to tobacco products.
7. In Sec. 10.3.1 of the Guide No. [CTGFZP1](#), FTA explains that '*repairs are typically classified as a service and the act of repairing involves restoring or fixing existing products to their original or functional state, rather than **creating a new product (manufacturing) or substantially changing the form or nature of a product (processing)***'. The manufacture of cigarettes from tobacco and other materials more closely aligns with the definition of manufacturing since it creates a new product rather than merely changing the form or nature of an existing product (tobacco).
8. Pursuant to this Guide, the Manufacturing comprises '*Production: **Converting raw materials into finished products**. This process may involve several stages and techniques, such as assembly line production, handcrafting, or utilising machinery. It may also include packing products for shipping, warehousing, or transporting to retail locations if this forms an integrated part of the production process*'.

In Processing function of production is not included, but "Processing" is defined as *the repetitive or continuous **action applied to good or materials**. It could involve activities like assembly, fabrication, machining, chemical reactions, printing, or packaging depending on the industry*".

9. On top of the above, the FTA instructs:
 - 1) '*Processing of goods or materials includes the preparation, treatment, transformation or conversion of goods or materials into another form of good or material for further **commercial or industrial use** or sale*'. This part does not provide arguments to interpret the factory's activities as processing since it creates a final product ready for consumption.
 - 2) '*Processing is typically, but not always, the middle step in the production process that involves changing the properties or form of the raw materials or semi-manufactured goods or materials to make them suitable for use or final manufacturing*'. Here, a distinction is also visible: manufacturing transforms raw materials, whereas processing does not transform raw materials into their final form but into semi-finished products ready for final manufacturing.
10. On the other hand, the FTA clarifies that '*processing is more typically seen in industries like food, oil refining, milling, etc. where **raw materials** undergo different treatments to become **ready for use***'. Therefore, processing can include:
 - treatment of raw materials, and

- The creation of a product form ready for consumption.

11. Furthermore, the FTA emphasize that a *'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'*. Hence, processing includes manufacturing. This means **any manufacturing can be defined as a type of processing**.
12. However, in examples 82-85 of the FTA Guide No. [CTGFZP1](#), it is indicated that sales should be made to *'Retailer/Distributor (not the end-user)'*. A factory purchasing tobacco and materials for cigarette production can be characterized as the end-user for tobacco. These examples can be used against qualifying the factory as an entity acquiring tobacco for resale or for resale after processing.
13. FTA Public clarification [VATP034](#) on Application of the Reverse Charge Mechanism on Electronic Devices among Registrants in the State for the purposes of VAT, dated October 8, 2023, clarified that *'resell' is 'to be understood as being a part of the Business of the Recipient of the Electronic Devices to trade in such devices. The resale by the Recipient of the Electronic Devices can be at a wholesale or retail level. A Recipient who is acquiring the Electronic Devices for use in his business, **other than for production or manufacturing, has no "intention to resell".'*** An example against resale is acquiring smartphones that are subsequently distributed to employees. This clarification is favorable for the situation in question as it allows characterizing the purchase of tobacco and materials for use in manufacturing as a purchase for resale.

This clarification is favorable for the situation at hand as it allows characterizing the purchase of tobacco and materials for use in manufacturing as a purchase for resale.

14. Corporate Tax legislation correlates the application of the 0% rate for distribution from a designated zone with VAT rules. Indeed, the zone must be recognized as Designated for VAT purposes to be considered designated for Corporate Tax purposes. This partial correlation allows for the use of other institutions and rules related to the Designated Zone for Corporate Tax purposes when Corporate Tax rules textually coincide or are textually similar to VAT rules.

The analysis of Designated Zones VAT Guide No. [VATGDZ1](#) allows for additional favorable assumptions for the situation in question. Section 3.3.2 determines that *'where a supply of goods is made within a Designated Zone to a person **to be consumed by him or another person** – in these situations... VAT will be applicable under the normal rules'*.

VAT rules on the Designated Zone distinguish supplies for 'consumption' (to the end-user) and supplies for 'resale'. According to the Guide, *'the term "consumed" should be interpreted broadly as including any utilisation, application, employment, deployment or exploitation of the goods. For the purpose of the provision, **the resale of purchased goods is not treated as consumption of the goods'***.

Besides, the Guide uses the same terminology as Decision No. [265/2023](#): *'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**'*.

Section 3.3.2 explains how to apply the relevant terms: *'supply can still be treated as being outside the scope of VAT when the purchased goods are:*

- *incorporated into, attached to or otherwise **form part of another good** located in the same Designated Zone and that other good is not consumed; or*
- ***used in the production of another good** located in the same Designated Zone **and that other good is not consumed**.*

*For the purposes of the second exception to the override, there must be a **direct connection between the purchased goods and the production of another good**. For example, the exception will generally apply to tools and equipment used to manufacture other goods; in contrast, a computer used by the business to create designs for goods which are later manufactured will not have sufficient connection with the goods to be treated as "used in the production" of the goods'.*

Applying these concepts, the sale of raw materials and materials to the factory for cigarette production can be characterized as the sale of goods for resale after processing.

15. However, it cannot be said that the conditions for applying VAT benefits in designated zones textually coincide with the conditions for applying the 0% corporate tax rate:

- For VAT, the condition for applying the benefit is a supply for purposes other than consumption, while for Corporate Tax, it is for purposes other than resale. VAT rules cite resale as one of the options when goods are not purchased for consumption by the buyer (reseller).
- For VAT purposes, there is a specific rule that adverse consequences characteristic of sale for consumption do not apply if the sale is made for the purpose *'to incorporate the Goods into, attach the Goods to, or that the Goods become part of or are used in the production of another Good in the same Designated Zone and such Good is not consumed'*. There is no such a rule in Corporate Tax legislation.

Therefore, the FTA may disagree that the principles and examples used in respect of VAT benefits are applicable to the 0% Corporate Tax rate.

16. In such a situation, it makes sense to obtain a private clarification from the FTA. According to para 8 of the FTA Private Clarifications Guide [TPGPC1](#): ***the FTA considers itself administratively bound to follow the position set out in the Clarification where the factual circumstances are materially the same as set out in the clarification form**. Please note that Clarifications are not considered to be a decision by the FTA, but rather the FTA's view on the application of the applicable legislation based on a specific set of facts.*

Consequently, Clarifications are not subject to the dispute resolution process...’.

On 12 of June 2024, the FTA issued [Decision No. 4](#) where it confirmed that *‘the Authority shall be **administratively obligated to follow this position** in circumstances where such clarification is relied upon and where the factual circumstances are the same as contained in the clarification form provided in the clarification Request’.*

Thus, the FTA cannot impose sanctions and collect taxes to taxpayer who obtained the clarification if doing so contradicts the position expressed in the clarification.

The disclaimer

Pursuant to the [MoF’s press-release](#) issued on 19 May 2023 *“a number of posts circulating on social media and other platforms that are issued by private parties, contain inaccurate and unreliable interpretations and analyses of Corporate Tax”.*

The Ministry issued a reminder that official sources of information on Federal Taxes in the UAE are the MoF and FTA only. Therefore, analyses that are not based on official publications by the MoF and FTA, or have not been commissioned by them, are unreliable and may contain misleading interpretations of the law. See the full press release [here](#).

You should factor this in when dealing with this article as well. It is not commissioned by the MoF or FTA. The interpretation, conclusions, proposals, surmises, guesswork, etc., it comprises have the status of the author’s opinion only. Like any [human](#) job, it may contain inaccuracies and mistakes that I have tried my best to avoid. If you find any inaccuracies or errors, please let me know so that I can make corrections.

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