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IP is developed from another IP acquired: Nexus Ratio calculation

In light of recent tax reforms, the UAE introduced retrospective tax benefits in October 2023 for the ownership and use of intellectual property. Qualifying income, such as from patents, software, and other IP assets, may be eligible for the 0% Corporate Tax rate. This regime aligns with OECD guidelines as outlined in the final BEPS report on Action 5, emphasizing the UAE's commitment to international tax standards.

Earlier, we published a snippet from the webinar related to embedded IP income. The group of slides below addresses cases where one intellectual property item is acquired to generate another one.

One IP asset bought to generate another



Example: acquisition of an algorithm



Example: acquisition of a patent



Libraries, frameworks, algorithms, code snippets



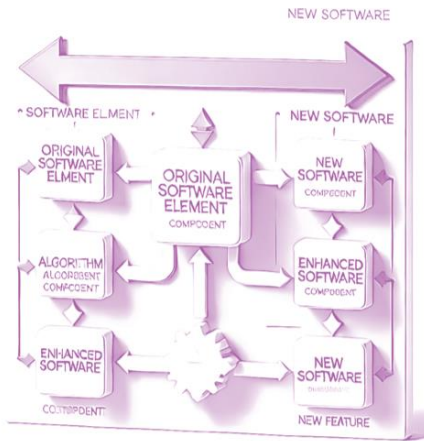
Adaptation, repurpose



New software product

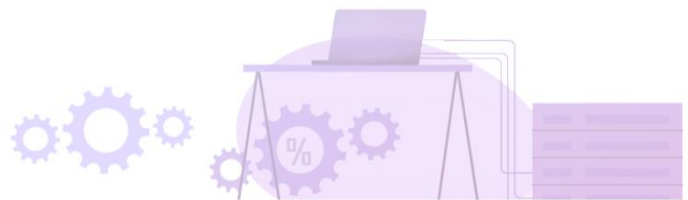
Acquisition costs decrease the share of income from IP when applying the 0% corporate tax rate. Should this unfavorable treatment apply to cases where one IP is integrated into another?

Acquisition costs in Nexus Ratio



Acquisition costs are not counted in the numerator, but are counted in the denominator, thereby diluting the Nexus Ratio.

What if one IP asset is acquired to develop another?



Practical scenarios are presented on slides 2, 6-8, and the rules for using them as a clue are on slides 3-5.

The relevant rules from the UAE tax legislation are singled out on the slides below:

Relevant rules for Acquisition costs

The R&D cost ... could include ... **cost of supplies** so long as all of these costs arise out of activities undertaken to advance the understanding of scientific relations or technologies, address known scientific or technological obstacles, or otherwise increase knowledge or develop new applications. However, ... acquisition costs... are not included in Qualifying Expenditure.

'If a QFZP **acquires Qualifying Intellectual Property** ..., the portion of the income that is attributable to the acquisition cost ... does not give rise to Qualifying Income'.



Cost of supply
VS
Cost of Acquisition of IP asset

Qualifying IP Asset
VS
Non-Qualifying IP asset (know-how, etc.)



In the UAE, IFRS rules serves as a starting point to determine the taxable amounts. They can be used to substantiate positive interpretation:

IAS 38:66(f)

The Standard differentiate between separately acquires assets and those generated internally.

Amortization of patents and licences that are used to generate the intangible asset must be included in the cost of an internally generated intangible asset.



Acquired
vs
Internally Generated



However, the OECD's Action 5 report impairs positive expectation.

Insights from the OECD's report

Acquisition costs would include, among other expenditures, those that were incurred to **obtain rights to research**

Outsourcing is different from the buying in of components from a party that owns the IP to those components, and this reference to the likelihood of outsourcing to unrelated parties does not refer to the likelihood of buying components from unrelated parties.

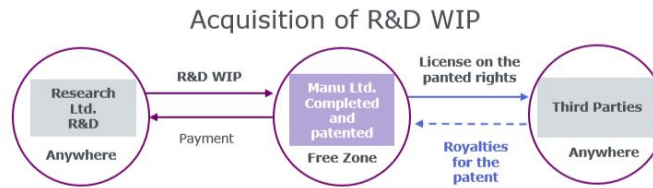


Buying in of components
vs
Outsourcing



The Irish Tax and Customs authorities' interpretation of similar wording was used to assess the opportunities and risks.

IP from IP: international practice



Manu Ltd buys Research Ltd.'s business. Research Ltd had a substantial body of work done in relation to a new product. Manu Ltd **takes that body of work and continues to carry out R&D on it and obtains a qualifying patent...**

The amount spent on **buying the body of research ... is an acquisition cost.**



IP as a part of acquired business



Acquisition costs regime and pertinent allocation



As part of the purchase of Research Ltd.'s business, Manu Ltd acquired a number of trade secrets which were the result of R&D. It decided **to do further R&D and to then obtain a qualifying patent in respect of some of those secrets** to protect them from an IP perspective and **to keep others as trade secrets** into the future. The costs of acquiring any trade secrets which are subsequently protected by a qualifying patent will be an **acquisition cost** for that qualifying asset. Where the secret is not protected by a qualifying patent then it is not within the scope of the KDB and any amount spent on acquiring the trade secret is not an acquisition cost. Where aspects of a trade secret are subsequently protected by a qualifying patent then it will be necessary to **apportion the acquisition cost** of the trade secret between that portion and the portion that remains unprotected.

The tax authority's position that '*much software development does not qualify as R&D activity*' is something to recon with.

Derivative works or adaptations

Software obtained, adapted and integrated to build new software product



High Tech Ltd **can recognize** as a qualifying asset:

- either the **adaptation (portion of the program)** that it developed),
- or the entire computer program (**family of assets**) as a single qualifying asset.

The elected option will impact on the amount of relief available.

Irish Revenue, Part 29-03-01, p. 55

Research and Development (R&D) Corporation Tax Credit

Part 29-02-03

This document should be read in conjunction with sections 766, 766A, 766B, 766C and 766D of the Taxes Consolidation Act 1997

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*"Undertaking routine analysis, copying, upgrading or **adaptation** of an existing product, process, service or material would **not** be considered to be **R&D activities**. Therefore, **much software development does not qualify as R&D activity**".*

Keep in touch with us to stay updated on further developments.

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 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.