How an upgrade and customization of the software affect 0% Corporate Tax rate?

The facts

The company is registered in Dubai Silicon Oasis. It develops software and licenses it to the customers. Generally, the software is licensed without any adaptation to the specifics of a particular customer. Occasionally, the Company licenses the software and fulfills the request for customization to meet the needs of specific customer, charging separate fees for this service.

Additionally, the company also distributes and customizes software solutions for software products developed by other persons and licensed from them.

The questions

May the company apply the 0% Corporate Tax rate for:

- the fees charged for customization of its own products,
- the remuneration received from customers for the sale or for the license of customized software obtained (licensed) from the third parties?

Should the Company's cost for customization and upgrade of the software increase Qualifying Expenditure in calculating the nexus ratio?

The summary

After considering the facts and the analysis below, we opine as follows:

1) DSO confirmed its status as a Free Zone for Corporate Tax purposes. Thus, the Company is a Free Zone Person and may qualify for the 0% Corporate Tax provided that other conditions are met.
2) Income generated from the customization of software products developed by the Company is Qualifying Income. However, the Company is advised to seek Private Clarification to confirm it.
3) Income from the customization of software developed by other persons is not Qualifying Income unless:
   a) the base program has been significantly improved, and
   b) new knowledge has been the major factor in such improvement.

   Where these conditions are met, only a portion of the income from the distribution of customized solutions may qualify—specifically, the portion calculated using the nexus ratio.
4) The customization costs doesn't affect the nexus ratio calculation unless the above conditions are met.

5) Upgrade costs may be included in Qualifying Expenditure if it embodies scientific or technological advances that result in an increase in the stock of knowledge.

6) The costs of obtaining a license to sell the customized solutions dilute the nexus ratio. They shall not be included in Qualifying Expenditures but must be included in the Overall Expenditures.

7) Test all costs against the R&D criteria. Exclude the costs which is specifically ruled outside the scope of R&D. Use the guidance in the Analysis to perform this assessment.

The analysis

1. Income of the Company should be subject to 9% Corporate Tax rate, unless it is considered a Qualifying Free Zone Person eligible for the 0% Corporate Tax rate.

   First and foremost, a company or its branch shall be registered in a Free Zone. Article 1 of the Corporate Tax Law authorizes the Cabinet to determine which free zones in the UAE shall qualify for the Corporate Tax purposes. However, the Ministry of Finance (MoF) and the FTA instruct the taxpayers to request information on the status of their zone from the free zone authorities:

UAE Corporate Tax Law	MoF, FAQ, Q.85	Free Zone Persons Guide CTGFZP1
A designated and defined geographic area within the State that is **specified in a decision issued by the Cabinet at the suggestion of the Minister**	85. Where can I find the list of Free Zones that are part of the Free Zone Corporate Tax regime? Contact your **Free Zone Authority to confirm the eligibility of the Free Zone** in which you operate **for the 0% Corporate Tax rate**.[1]	All taxpayers should **check with their respective Free Zone Authority to confirm if they operate in a Free Zone** or Designated Zone **for Corporate Tax purposes**.

2. Dubai Silicon Oasis has recently announced that:

> **Corporate Tax**
>
> Dubai Silicon Oasis is 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 (Federal Decree-Law No. 47 of 2022 on Taxation of Corporations and Businesses and its amendments). This allows businesses operating in the Dubai Silicon Oasis Free Zone to benefit from a 0% Corporate Tax rate on qualifying income as specified by the relevant Corporate Tax Cabinet and Ministerial decisions. For more information on Corporate Tax Law, please refer to the website of Ministry of Finance (English, Arabic).

[1] See also information from the Symposium on Public Financial Policies and Labor Market organized by the MoF: '*Businesses can contact their Free Zone Authority to confirm whether that Free Zone is eligible for the 0% rate*'.

Hence, this Zone is considered a Free Zone for Corporate Tax purposes, and being registered therein, the Company is deemed a Free Zone Person.

3. In order to be considered a Qualifying Free Zone Person, the following conditions should be met:[2]

   1) To maintain adequate substance in the UAE;
   2) To derive Qualifying Income;
   3) To not elect to be subject to Corporate Tax;
   4) To comply with the requirements under the Arm's Length Principle and transfer pricing documentation;
   5) To meet de minimis requirements;
   6) To prepare audited financial statements.[3]

   If the Company does not meet any of these conditions at any time during the tax period, the Company loses the right to the 0% Corporate Tax for 5 years.[4]

   Therefore, it is of utmost importance to ensure that UAECo can meet the above requirements to enjoy the 0% Corporate Tax rate.

4. The attributes of Qualified Income are set out in:

   - the Cabinet Decision No. 100 of 25.10.2023
   - the Ministerial Decision No. 265 of 27.10.2023.

   Besides, on 20 of May 2024 the FTA issued a Corporate Tax Guide on Free Zone Persons No. CTGFZP1.

5. Article 3(1)(c) of the Decision No. 100/2023 treats Qualified Income as '*income derived from the ownership or exploitation of* ***Qualifying Intellectual Property*** *under Clause (1) of Article (7) of this Decision'.*

   Article 1 of this Decision defines Qualifying Intellectual Property as *'Patents****, Copyrighted Software*** *and any right functionally equivalent to a Patent …'*. The same article defines Copyrighted Software as ***'any copyright subsisting in software granted under the law regulating copyrights in the State or granted under the relevant law of a foreign jurisdiction'***.

   Article 2 (2) of the Copyrights Law[5] determines that '*works under protection Authors of Works and Holders of Neighboring Rights shall enjoy the protection provided for in this Decree Law, if their rights are violated*

[2] Art. 18(1) of the Corporate Tax Law.
[3] Article 5 (1) of the Ministerial Decision No. 265
[4] Ibid, Article 5 (2)
[5] Federal Decree-Law No. (38) issued on 20 September 2021 On Copyrights And Neighboring Rights.

*within the State, namely as concerns the following Works – **Smart applications, computer programmes and applications**, databases, and similar Works determined by a decision of the Minister*'.

Therefore, income derived by the Company from the ownership and exploitation of the software could be treated as Qualifying Income subject to the 0% Corporate Tax rate.

6. Article 4(1)(a) of the Decision No. 265/2023 requires, '*for the purposes of determining what income from Qualifying Intellectual Property is to be considered Qualifying Income'* to '*maintain all records, books and documents that prove … **ownership and the right to exploit** the Qualifying Intellectual Property*'. The conjunction "and" should not be construed to mean that both 'ownership and the right to exploit' are required to qualify income to qualify income. Article 3(1)(b) of the Cabinet Decision No. 100/2023 includes in the list of Qualifying Incomes an '*income derived from the ownership **or** exploitation of Qualifying Intellectual Property under Clause (1) of Article (7) of this Decision*'. Article 7 also refers to an income from '*ownership **or** exploitation*'. Article 4(1)(a) of the Decision No. 265/2023 also implies that the right to exploit may suffice. Otherwise, there would be no need to address the right to exploit an addition to ownership, since ownership inherently includes the right to exploit the property.

   Therefore, the income derived from the software owned by the Company may definitely qualify for the 0% rate. Income generated from the software owned by other persons but licensed to the Company for the purpose to exploit in order to sell the customized software solutions may also be considered as income derived from the exploitation of the Qualifying IP.

7. Article 4(2)(c) of the Decision No. 265/2023 defines 'Overall Income' as '*royalties or any other income derived from Qualifying Intellectual Property …, **including embedded intellectual property income derived from the sale of products and the use of processes directly related to the Qualifying Intellectual Property** …*'. In our view, the customization of the software that the Company sells or licenses is an integral and natural part of the 'IP ownership or exploitation' activity. The customization fees are the condition under which the customer buys the IP. Thus, we believe that the customization income derived from software that company owns or exploits, may be treated as income from 'ownership or exploitation of Qualifying IP'.

8. However, Article 7 of the Decision No. 100/2023 and Article 4 of the Decision No. 265/2023 qualify not all income from the exploitation of Qualifying IP but only that part which passes the nexus ratio test.

There is only research and development (R&D) costs may be included in the calculation of the nexus ratio. [6] Section 9.5. of Corporate Tax Guide on Free Zone Persons No. CTGFZP1 directly states that *'acquisition costs… are not included in Qualifying Expenditure'*. Therefore, the acquisition cost of the computer software should not be included in Qualifying Expenditures (the numerator of the ratio). However, they must be included in the Overall Expenditures[7], i.e., in the denominator of the ratio.

Hence, for software developed by another person and licensed to the Company to produce and sell customized software, the company shall include the license fees into the denominator of nexus ratio and may not include them in the numerator.

9. Since the Qualifying and Overall Expenditures include only R&D costs, any expenses for amendments to existing software may only qualify if these amendments meet the definition of R&D.

   Section 9.5 of the FZ Person Guide mentions *'general and speculative R&D'* in rules: *'Where expenditures for **general and speculative R&D** cannot be included in the Qualifying Expenditures of a specific Qualifying Intellectual Property asset to which they have a direct link, they may be divided pro-rata across Qualifying Intellectual Property assets or products'*. This indicates that not only speculative R&D, such as the development of new software, but also general R&D, such as developing an upgraded version of existing software, may be included in Qualifying Expenditure.

   However, the operations of the Company shall be carefully tested to distinguish works with R&D attributes from works where such attributes are missing.

   On 14 of May 2024, the UAE Ministry of Finance released Guidance Paper on the Foundations of R&D. The Guidance doesn't specifically mentions amendment of the existing software but it includes in the list *'of the most common R&D activities'*:

   - *'modifying or changing the composition of product components or re-design processes for production',* and
   - *'Designing **tools**, equipment and moulds **incorporating new technologies**'.*

   The Guidance sets forth with *'engineering and scientific activities [which] are often **excluded from R&D** activities when they fall within the following areas',* such as:

   a) *Subsequent engineering operations after development are completed in the early stage of commercial production…*

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[6] Paragraphs (a) and (b) of Art. 4(2) of the Ministerial Decision No. 265/2023.
[7] Art. 4(2)(b) of the Decision No. 265/2023.

b) *Inspection and maintenance works, such as troubleshooting during commercial production*…

c) ***Adapting the capabilities available to meet specific requirements or specific needs of the customer as an integral part of an ongoing business activity***…

d) *Other occasional or regular changes to the design relating to existing products*.

e) *Routine design of various tools, equipment, and moulds*.

This Guidance contains a table with R&D characteristics and recommends a test designed to establish the presence of these characteristics. It makes sense, to conduct this test for every function related to the subsequent development of the software and to keep the results of such testing recorded and available for the tax audit period.

10. The above Guidance Paper refers to the 'Frascati Manual'. This manual includes provisions that specifically address software R&D:

1) '*Development of new applications software and substantial improvements to operating systems and application programmes are experimental development*'.[8]

2) '*General differences between basic and applied research and experimental development*' are illustrated with example '*in computer and information sciences*'. This example breaks down R&D in:

a) '*Basic research: Research on the properties of general algorithms for handling large amounts of real-time data.*

b) *Applied research: Research to find ways to reduce the amount of spam by understanding the whole structure or business model of spam, what spammers do, and their motivations in spamming*.

c) *Experimental development: A start-up company takes code developed by researchers and develops the business case for the resulting software product for improved on-line marketing*'.[9]

Therefore, if the Company's input falls under these examples or has similar substantial characteristics, the functions corresponding to such input are likely to be deemed as R&D.

3) '*Software development is an innovation-related activity that is* ***sometimes connected with R&D*** *and incorporates,* ***under specific conditions****,* ***some*** *R&D. For a software development project to be classified as R&D, its completion* ***must be dependent on a scientific and/or technological advance,*** *and the aim of the project*

[8] Para 2.40.
[9] Ibid.

*must be the **systematic resolution of** a scientific and/or **technological uncertainty***'.[10]

4) '*The nature of software development is such that it is difficult to identify its R&D component, if any. Software development is an integral part of many projects that in themselves have no element of R&D. The software development component of such projects, however, may be classified as R&D if it leads to an advance in the area of computer software. **Such advances are generally incremental rather than revolutionary.** Therefore, **an upgrade, addition or change to an existing program or system may be classified as R&D if it embodies** scientific and/or **technological advances that result in an increase in the stock of knowledge**. The use of software for a new application or purpose does not by itself constitute an advance*'.[11]

5) '*The following examples illustrate the concept of R&D in software and should be included in R&D*:

   a) the development of new operating systems or languages

   b) the design and implementation of new search engines based on original technologies

   c) the effort to resolve conflicts within hardware or software based on the process of re-engineering a system or a network

   d) the creation of new or more efficient algorithms based on new techniques

   e) *the creation of new and original encryption or security techniques*'.[12]

   On the other hand, para 2.72 provides for the example of the '*software-related activities of a routine nature*', which may '*not to be considered R&D. Such activities include work on system-specific or program specific advances that were publicly available prior to the commencement of the work'.*

   Furthermore, '*technical problems that have been overcome in previous projects **on the same operating systems and computer architecture** are specifically excluded from R&D*'. Routine software maintenance is not included in R&D as well.

   Examples of other software-related activities, which are excluded from R&D are:

   - '*the development of business application software and information systems **using known methods and existing software tools***';

[10] Para 2.68.
[11] Para 2.70.
[12] Para 2.71.

- '***adding user functionality to existing application programs*** *(including basic data entry functionalities)*';
- '*the creation of websites or software* ***using existing tools****…*'
- '*the* ***customization*** *of a product for a particular use,* ***unless during this process knowledge is added that significantly improves the base program***'
- '*routine debugging of existing systems and programs, unless this is done prior to the end of the experimental development process*'.

11. Assessing the above characteristics of R&D is essential to determine whether expenses should be included in the calculation of the nexus ratio.
12. Applying above findings to the situation at hand, we may conclude that:
    1) Customization shall not fall within the scope of R&D unless:
        a) the base program has been significantly improved, and
        b) new knowledge has been the major factor in such improvement.

    Where the above conditions are not met, the customization costs shall not be included in the calculation of the ratio. This means that:

    - The nexus ratio for software obtained (licensed) from other persons will be zero. Acquisition, distribution and customization costs shall not be included in the R&D expenditures and calculation of the nexus ratio. Therefore, the Company may not qualify any income from the distribution of IP developed by other persons.
    - The nexus ratio for software developed by the Company itself or under its supervision[13] will not be affected by the customization costs. The Company will retain the right to qualify by virtue of the expenditures incurred on the development of software.

    2) The upgrade of software developed by the Company itself or under its supervision may increase the nexus ratio if it embodies scientific or technological advances (see above).

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

[13] Any supervised provider from the UAE counts and only Independent providers from the rest of the world.

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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