

Tax Alert

UAE



Key Changes in Determining Qualifying Income of a Qualifying Free Zone Person

Cabinet Decision No.100 and Ministerial Decision No.265 of 2023

Another development in the UAE Corporate Tax (UAE CT) framework comes pursuant to the public consultation paper released by the UAE Ministry of Finance (MoF) on 19 July 2023 for the classification of Qualifying Activities and excluded activities.

The MoF has repealed the decisions issued earlier for determining the Qualifying Income (QI) of a Qualifying Free Zone Person and defining Qualifying Activities and Excluded Activities. The same is now replaced with new decisions that give additional clarity on a few aspects and introduce some new benefits for the taxpayers, especially with respect to the exploitation of Intellectual Property Rights and trading in Qualified Commodities.

The key changes as per the new decisions are explained below:

Income from Qualifying Intellectual Property

Income derived from the ownership or exploration of Qualifying Intellectual Property (QIP) shall be treated as Qualifying Income (QI). Earlier, the same was an excluded activity, but now, it is specifically treated as QI subject to meeting certain conditions and is to be computed as per the prescribed formulae.

QIP is defined to include patents, copyrighted software and any right functionally equivalent to a patent if it is legally protected and subject to similar approval and registration process. Some examples of QIP given in the definition are:

- Utility Models
- Intellectual property assets that grant protection to plants and genetic material
- Orphan drug designations
- Extensions of Patent protection.

It is interesting to note that marketing-related Intellectual property, such as trademarks, etc. are specifically excluded from being treated as a QIP.

QI from QIP would be computed as per the formulae given below. Non-QI from QIP would be directly taxed at 9% and would not be considered while computing the de-minimis limit.

QI from QIP shall be determined as follows:

$$\text{Qualifying Income} = \frac{\text{Qualifying Expenditures} + \text{Up-lift Expenditures}}{\text{Overall Expenditures}} \times \text{Overall Income}$$

In the above formula, the terms would mean as follows:

- **Qualifying Expenditures:** Expenditures incurred to fund research and development activities, conducted either by the Qualifying Free Zone Person (QFZP) or outsourced to any Person in UAE or any Person outside the UAE that is not a Related Party, directly connected with the creation, invention or significant development of the QIP.
- **Overall Expenditures:** Total expenditures incurred to fund research and development activities, conducted either by the QFZP or outsourced to any Person, directly connected with the creation, invention or significant development of the QIP, including acquisition costs of the QIP.
- **Overall Income:** Royalties or any other income derived from QIP, including embedded intellectual property income derived from the sale of products and the use of processes directly related to the QIP as determined in accordance

with the arm's length principle.

- **Up-lift Expenditures:** Qualifying Expenditures increased by 30%. However, such expenditure can be considered provided that the Qualifying Expenditures after being up-lifted do not exceed overall expenditures.

Furthermore, a QFZP earning income from QIP shall maintain such records, books and documents to substantiate the amount of income from QIP treated as QI. Eg: documents of ownership or right to exploit the QIP, link between Qualifying Expenditures and Overall Income derived from QIP.

Furthermore, core income-generating activities in respect of QIP can be outsourced to any other Person in UAE and to any other Person who is not a Related Party outside UAE, provided the QFZP has adequate supervision of the outsourced activity.

Trading of Qualifying Commodities

Trading of Qualifying Commodities is newly added to the list of Qualifying Activities. The scope includes:

- physical trading
- associated derivative trading on a recognized commodities exchange market established in UAE or outside UAE.

Qualifying Commodities are defined as metals, minerals, energy and agriculture commodities traded in raw form.

Explanations given for various Qualifying Activities

The public consultation paper provided the scope of various Qualifying Activities along with certain illustrations. Largely, the said scope is now incorporated in the new ministerial decision with some modifications. The relevant changes to the scope of Qualifying Activities are detailed in subsequent paragraphs.

Holding of shares and other securities for investment purposes:

- Earlier, the Qualifying Activity was named holding of shares and other securities. The purpose of holding has been newly added. It is provided that shares and other securities shall be deemed to be held for investment purposes if they are held for at least an uninterrupted period of 12 months.
- Furthermore, holding of other securities would include Negotiable or non-negotiable financial instruments, including derivative instruments, financial commodities, and other investment instruments that are or can be traded in a public or private market or that are convertible or exchangeable into security or which confer a right to purchase a security, with the exception of the holding of financial or **investment instruments that are issued pursuant to securitization of receivables from a non-financial asset.**
- Earlier, there were certain qualifying requirements to be fulfilled by a QFZP for holding of other securities. This requirement has now been removed.

Ownership, Management and Operation of ships (for international transportation):

- Towing activities and dredging activities at sea are specifically included in the scope.
- Ships used for local transportation or leisure or recreational purposes, or as floating hotels, restaurants or casinos are specifically excluded from the scope.

Fund Management Services

- Discretionary and non-discretionary fund management services are now included in the scope.

Wealth and Investment Management Services

- Wealth and investment management services have been broadly defined to include activities of providing discretionary and non-discretionary investment management and advisory services, portfolio management and wealth and investment advisory services that are subject to the regulatory oversight of the Competent Authority in the State.

Financing and Leasing of Aircrafts

- Management and brokerage services in relation to the financing or leasing activity undertaken by the QFZP are excluded from the scope.

Distribution of goods or materials definition broadly remains the same as provided in the earlier decision:

- 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.
- The wording used in the above definition creates doubt as to whether there is a requirement to bring the goods into UAE for the activity to be considered as a Qualifying Activity. However, if we go by the public awareness session conducted after the issuance of original decisions and the example provided in the public consultation document released in July, a position can be adopted that bill to ship to transactions would be a Qualifying Activity.

Additionally, the MoF has clarified that the reinsurance activities included in the list of Qualifying Activities and the banking and insurance activities included in the list of excluded activities shall be covered in the regulations governing these activities¹.

- The competent authorities are specifically defined to include only the Central Bank of UAE, the Dubai Financial Services Authority (DFSA) of the Dubai International Financial Centre (DIFC), the Financial Services Regulatory Authority (FSRA) of the Abu Dhabi Global Market (ADGM) and the Securities and Commodities Authority.
- Furthermore, finance and leasing activities are defined to mean the provision of credit or financing for any kind of consideration and the letting or otherwise granting the right to use an asset in exchange for rental or other consideration pursuant to a finance lease, operating lease or other arrangement, that are subject to the regulatory oversight of the Competent Authority in the State.
- Activities ancillary to Qualifying Activities are explained in the new decision as such activities necessary for the performance of the main activity or where it makes a minor contribution to it and is so closely related to the main activity that it should not be regarded as a separate activity.

1. Insurance & Reinsurance services – Federal Law No.6 of 2007 Banking Activities – Article 65 of Federal Decree-Law No.14 of 2018

Other relevant changes in the decisions

- Transactions with Free Zone Persons who are not beneficial recipients of relevant goods and services shall be considered as non-qualifying revenue for computing the de minimis limit.
- Core income-generating activities are defined to consist of those significant functions that drive the business value for each activity carried out by a QFZP and are not exclusively or mostly support activities.
- Maintaining adequate substance in the Free Zone - if the core income-generating activities of a QFZP are conducted in a designated zone where they are so required to be conducted, then such activities shall also be regarded as core income-generating activities to maintain adequate substance.
- Furthermore, to fulfill the substance criteria the QFZP, the new decision mandates having an adequate number of full-time employees.
- Outsourcing to a Person in the designated zone is now allowed if activities are required to be conducted in such a designated zone.

Our Comments

The new decisions released by the UAE MoF provide the much-needed clarity on various Qualifying Activities especially regarding investment and wealth management activities which is one of the backbone of the UAE economy. However, certain activities like arranging debts, arranging insurance, and assisting in M&A activities which are covered by the license issued by DIFC and ADGM but may not get covered as Qualifying Activities. Companies need to evaluate the same carefully.

While most aspects have been clarified, uncertainty remains on the distribution activity where goods do not enter the UAE. Also, given that many large Free Zones like DMCC are not designated zones, any distribution activity conducted through those Free Zones may also be impacted significantly.

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