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Thin Capitalization and UAE's Interest Limitation Approach

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Agenda

- Story behind thin capitalization and its Adoption in the UAE.
- Key Issues in Thin Capitalization highlighted in OECD
- The OECD’s Approach to tackling Thin Capitalization
- Understanding Interest Deduction Limitations under UAE CT Law
- Key Takeaways on Thin Capitalization Norms in UAE Tax Law
- Thin Capitalization : Practical Considerations

The Story Behind Thin Capitalization and its Adoption in the UAE

Thin capitalization refers to a situation where a company is **financed through a relatively high level** of debt compared to equity.

The capitalization structure of a company can have a **significant impact on the profit** it reports and, therefore, the amount of tax it pays.

The higher the level of debt in a company, the **more interest it pays, resulting in a lower taxable profit** or tax base.

Thin capitalization rules are designed to **prevent cross-border shifting** of profits through excessive debt and to **protect a country's tax base.**

In accordance with the OECD's **BEPS Action Plan 4,** Chapter 9 of the Federal Decree-Law No. 47 of 2022 (UAE CT Law or Law), has incorporated **Article 30 - General Interest Deduction Limitation Rule.**

UAE has gone one step further to incorporate **Article 31 i.e., specific interest deduction rule.**

Ministerial Decision no. 126 of 2023 give detailed rules for the **operation of Article 30.**

Key Issues in Thin Capitalization Highlighted by the OECD

Multinational groups can achieve favorable tax results by adjusting the amount of debt in a group entity. Base Erosion and Profit Shifting (BEPS) risks may arise in three basic scenarios:

1. Groups placing **higher levels of third-party debt** in high-tax countries.
2. Groups using **intragroup loans** to generate interest deductions that exceed the group's actual third-party interest expense.
3. Groups using third-party or intragroup financing to **fund the generation of tax-exempt income.**

Illustration

Company A

Debt: AED 1000 @ 10% interest

Company B

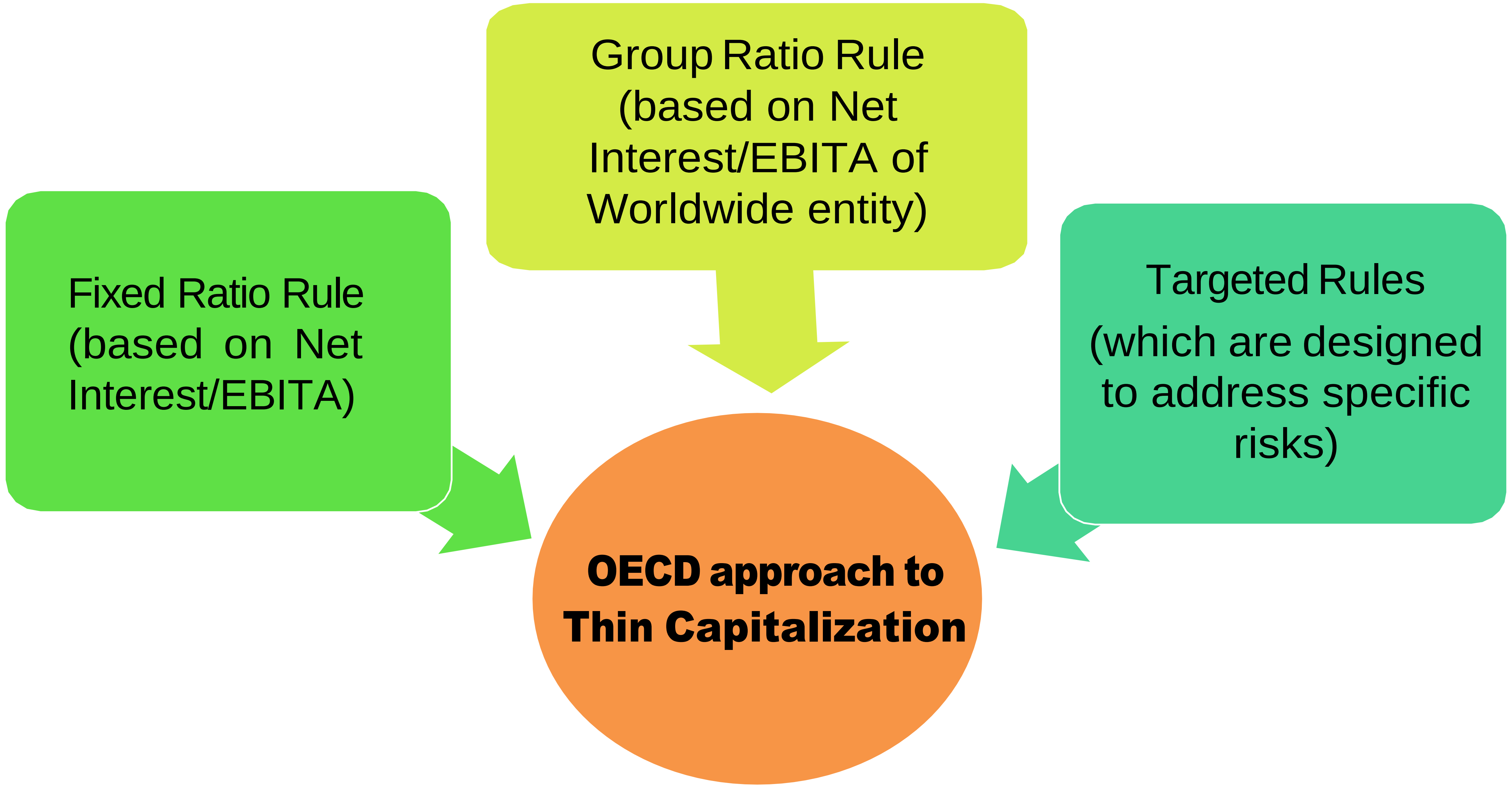
Loan Scenario

Particulars	Co A	Co B	Group
Corporate Tax Rate	15%	35%	-
Operating Profit	-	150	150
Interest Income from Co B	100	-	100
Profit Before Interest & Tax	100	150	250
Interest Paid to Third Party	-	130	130
Interest paid to Co A	-	100	0
Profit Before Tax	100	(80)	20
Corporate Tax	15	(28)	(13)
Profit After Tax	85	(52)	33

No Loan Scenario

Particulars	Co A	Co B	Group
Corporate Tax Rate	15%	35%	-
Operating Profit	-	150	150
Interest Income from Co B	0	-	0
Profit Before Interest & Tax	0	150	150
Interest Paid to Third Party	-	130	130
Interest paid to Co A	-	0	0
Profit Before Tax	0	20	20
Corporate Tax	0	7	7
Profit After Tax	0	13	13

The OECD's Approach to Tackling Thin Capitalization



UAE's Interest Limitation Approach: Understanding Fixed Ratio Approach, Pros & Cons

- The UAE has adopted Ratio Approach (Fixed Ratio) to limit the deduction of interest.
- Under the Fixed Ratio rule, interest payments on debt can be deducted up to a certain limit, such as a certain percentage of EBITDA. Any additional interest beyond this limit would not be deductible for tax purpose.

Pros of Ratio Approach

Great deal of **certainty** to taxpayers

Provides more **rational** approach

Relatively **simple** to implement

Reduces the **resource costs** of tax authorities

Decreases compliance burden on companies

Cons of Ratio Approach

May **not accurately reflect** economic reality.

Can **distort behavior** by group affiliates

May not consider specific **market situations** or industries.

May lead to **inconsistent treatment** of MNEs compared to independent companies.

There is **no agreed-upon international standard** for the formulation of an appropriate ratio.

Illustration on application of Ratio approach

Country x

Company A

Equity capital-10
Loan from Co. A: 90 @10% interest rate

Interest: 9 (90x10%)

Country Y

Company B

Debt equity ratio-2:1

Pre interest income: 15

Interest deductibility :

- 7 disallowable for tax purpose (excess of equity will be denied)
- 2 allowable for tax purpose

Industry Wise Indicative Optimum Debt Equity Ratio

Industry	Debt-to-Equity Ratio Range
Utilities	2.0 - 3.0+
Capital Intensive Manufacturing	1.0 - 2.0
Retail	0.5 - 1.5
Technology	0.3 - 1.0
Pharmaceuticals/Biotechnology	0.2 - 0.5
Healthcare Services	0.5 - 2.0
Consumer Goods	0.5 - 1.5
Real Estate	Highly variable

This ranges might vary based on certain factors like economic circumstances, industry life cycles, Company life cycles and others

Understanding Interest Deduction Limitations under UAE CT Law

Article 30 – General Interest Deduction Limitation

- **Net interest expenditure*** shall be deductible to the extent of **30% of EBITDA****
- The amount which exceeds the limit can be carried forward for a period **of 10 Financial years**
- The above shall not be applicable to
  - A bank,
  - an Insurance provider,
  - natural person undertaking business activity in the state

Article 31 - Specific Interest Deduction Limitation Rule

- **No Deduction** shall be allowed for the loans availed form related parties directly or indirectly in respect to following transaction:
  - A dividend or profit distribution to a Related Party
  - A redemption, repurchase, reduction or return of share capital to a Related Party.
  - A capital contribution to a Related Party.
  - The acquisition of an ownership interest in a Person who is or becomes a Related Party following the acquisition
- Interest expenditure shall be allowed if the taxpayer is able to demonstrate that the main purpose of the debt/loan is not obtaining a corporate tax advantage***

** Net interest Expenditure = General Interest Expenditure - Interest Income*
*** EBITDA - Earnings Before the deduction of Interest, Tax, Depreciation and amortization*
**** No Corporate Tax advantage shall be deemed to arise where the Related Party is subject to Corporate Tax of at least @ 9%*

Illustrations on Specific Interest Deduction Limitation

Illustration 1

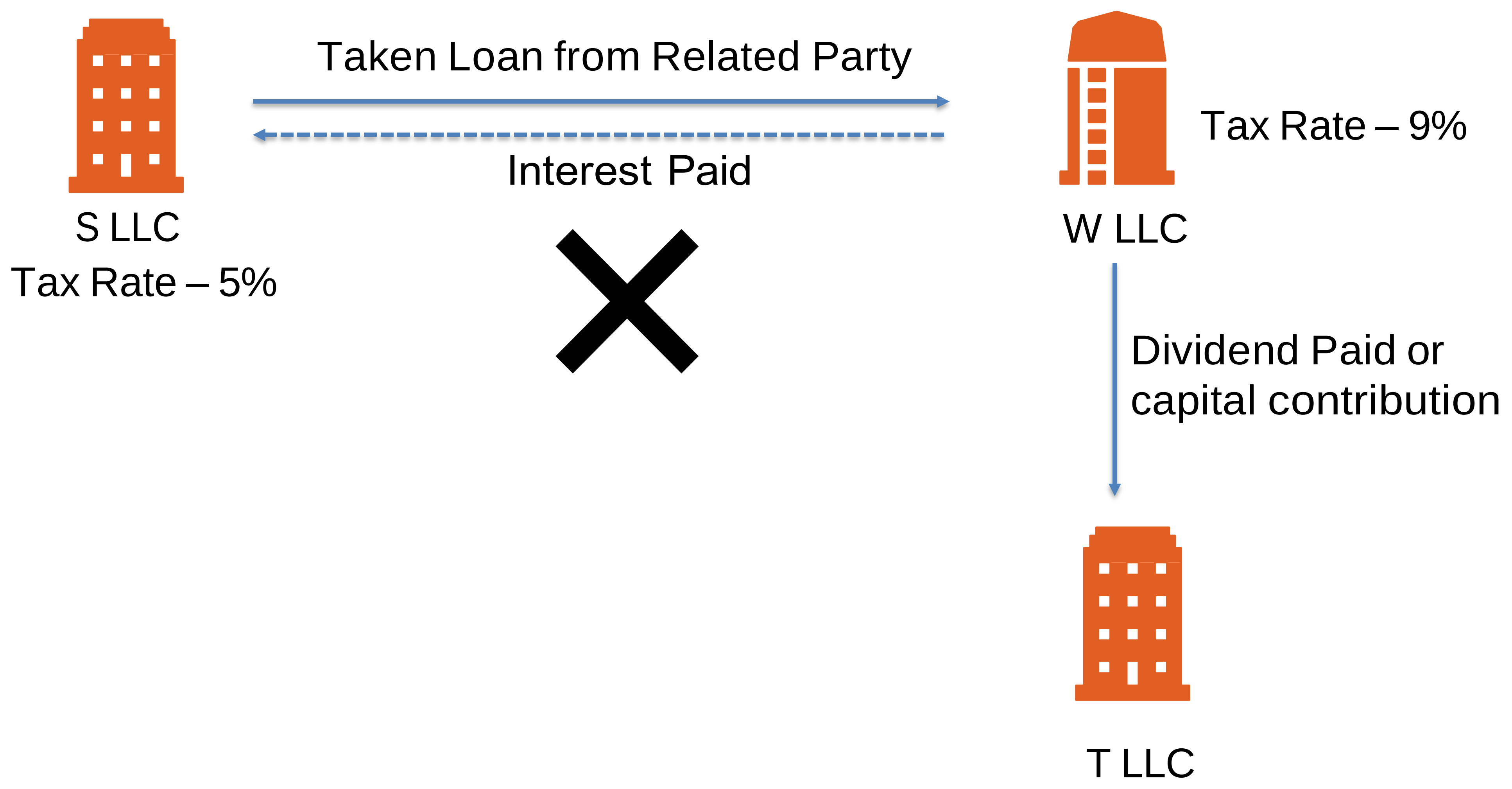
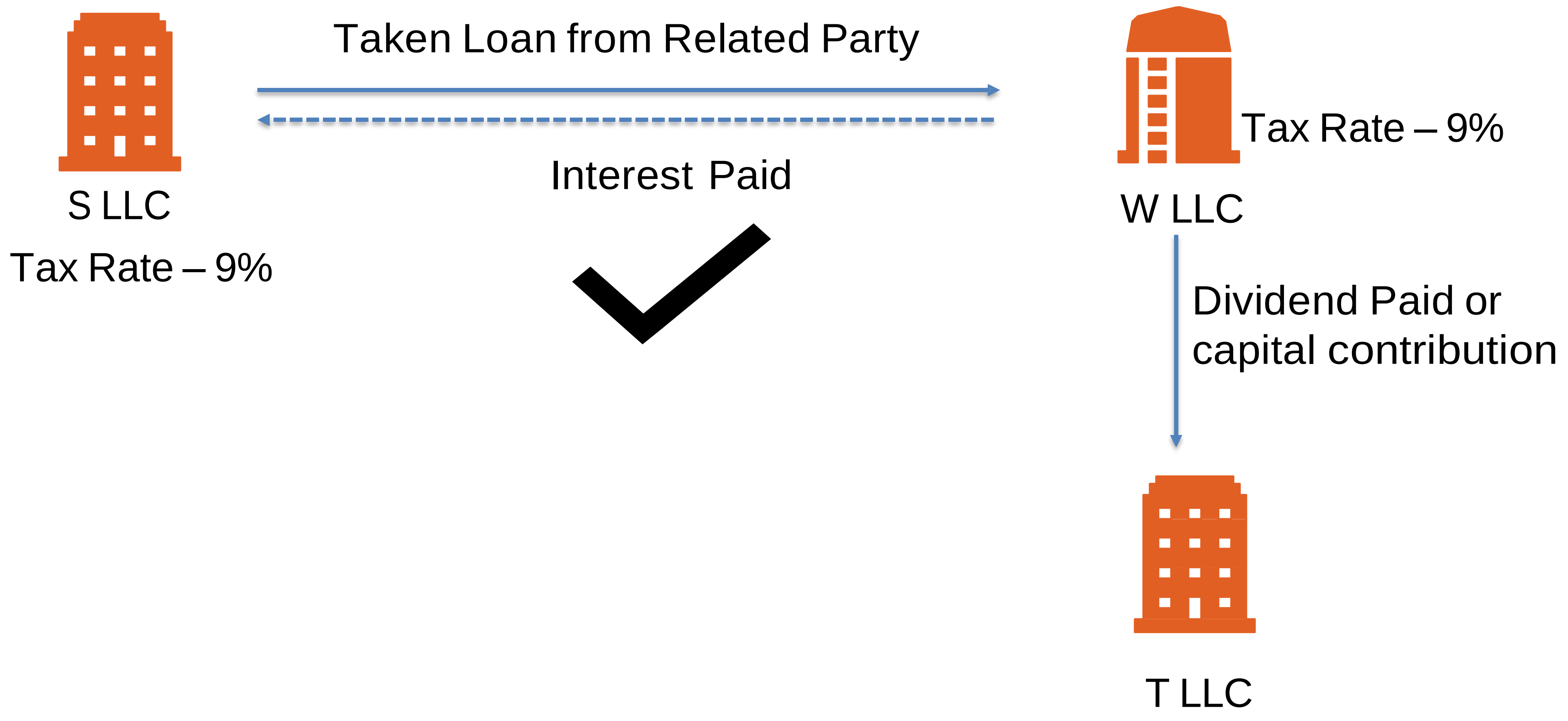


Illustration 2



Thin Capitalization: Practical Considerations

- Specifically, interest income earned **by individual shareholders /promoters is not subject to CT,** whereas interest payment is allowed as deduction for borrowers.
- **ALP test –** TP Adjustments overrides interest deduction limitation?

- **Startups** may be adversely affected by linking interest deduction to EBITDA

- **Whether deemed loans** – related parties are subject to **interest limitation**?
- **Interest imputation** on closing balances due to **transitional rules**, whether grandfathering allowed?
- Whether interest on **account of breach** of contract **subject to** interest deduction limitation?

Practical Considerations

- What constitutes optimal debt **equity ration** from UAE CT standpoint?
- **Shareholder activity** criteria that results in **no interest charge**?

- **Deferred tax analysis** for **interest disallowances** and carryforward?
- In case of a **disallowance,** whether there is any corresponding **reduction in taxable income** of the domestic lender who is subject to tax?

Illustration on Interest Deduction as per UAE Tax Law

Year 1

Particulars	Amount (in AED)
Tax Period 1	
Interest Income	30
EBIDTA including exempt income	100
Exempt Income	20
General Interest Expenditure	70
Specific Interest Expenditure	10

Computation of Interest allowed

Particulars	Amount (in AED)
Computation of Interest Allowed	
EBITDA (100 – 20) **(A)**	80
30% of EBITDA (A)*30% **(B)**	24
Net Interest Expenditure (General Interest Expenditure – Interest Income) **(C)**	40 (70-30)
Carry forward interest for 10 years (C – B)	16 (40-24)
Specific interest expenditure (No carry forward allowed)	10

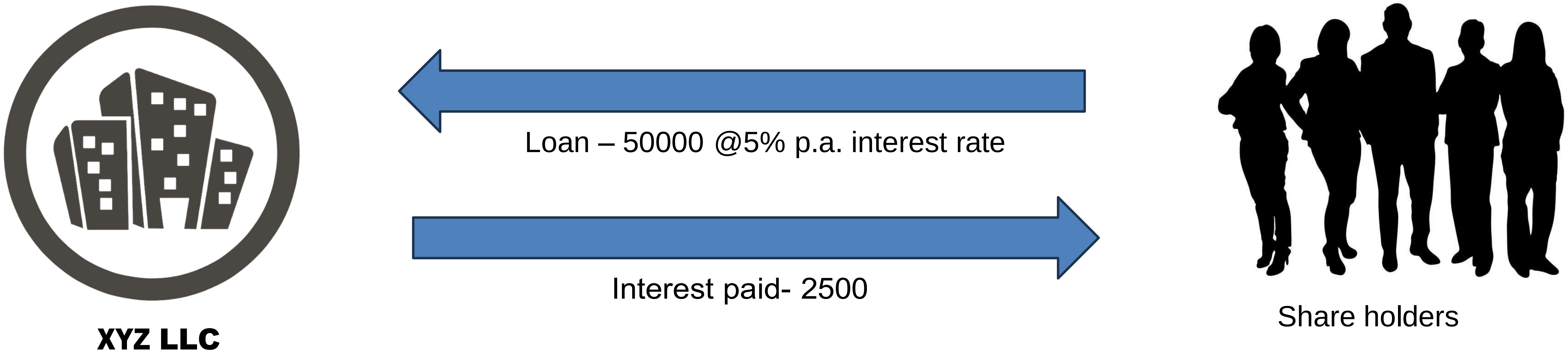
Year 2

Particulars	Amount (in AED)
Tax Period 2	
Interest Income	40
EBIDTA including exempt income	130
Exempt Income	25
General Interest Expenditure	60
Specific Interest Expenditure	5

Computation of Interest allowed

Particulars	Amount (in AED)
Computation of Interest Allowed	
EBITDA (130 – 25) **(A)**	105
30% of EBITDA (A)*30% **(B)**	31.5
Net Interest Expenditure (General Interest Expenditure + C/f interest expenditure – Interest Income) **(C)**	36 (60+16-40)
Carry forward interest for 9 years (C – B)	4.5 (36-31.5)
Specific interest expenditure (No carry forward allowed)	5

Illustration



Before Loan Scenario:

- Manufacturing industry
- Industry average debt-to-equity ratio- 2:1
- Total assets - 50000
- Equity - 50000

After loan scenario:

- Debt-to-equity ratio-1:1
- Interest received by shareholders - 2500 (not taxable)
- Interest paid- 2500 (deducted as expense & reducing its taxable income & lower its corporate tax liability.

Key Points – MD 126 of 2023 (1/2)

- **Interest include the interest component of the following:**
  - Performing and non-performing debt instruments.
  - Interests in collective investment schemes focused on cash and cash equivalents.
  - Collateralized asset-backed debt securities and similar instruments.
  - Agreements for selling and repurchasing securities at a future date.
  - Stock lending agreements with the right to reacquire the security.
  - Securitizations involving asset transfer for issuing securities.
  - Lease or hire purchase arrangements transferring ownership risks to the lessee.
  - Factoring and similar accounts receivable purchase transactions.
- **In addition to above the following shall also be considered interest:**
  - Guarantee fees.
  - Arrangement fees.
  - Commitment fees.
- **Interest component of the following hedging instruments:**
  - forward contracts
  - futures contracts
  - options
  - interest rate and foreign exchange swap agreements
- **Interest component on Islamic financial instrument**
- **The finance element of finance lease payments and non finance lease payments**

Whether shareholder's current account is considered as equity or debt?

Key Points – MD 126 of 2023 (1/2)

- This limit of 30% on EBITDA shall not apply where the interest expenditure is less than or equal to AED 12,000,000.
- **EBITDA shall be calculated as follows:**
  - Taxable Income calculated as per Article 20

    +
  - Net Interest Expenditure for the relevant Tax Period

    +
  - Depreciation and Amortisation

    +
  - Any Interest income or expenditure relating to grandfathered financial assets or liabilities
- Pre-9 December 2022 debts and contracts are exempt from the Interest Deduction Rule.
- Net Interest Expenditure for pre-9 December 2022 debts is the lower of actual or pre-December 9, 2022 terms.
- When a subsidiary joins a tax group, its carried forward Net Interest Expenditure can only offset the taxable income attributable to that subsidiary.

Key Takeaways on Thin Capitalization Norms in UAE Tax Law

General interest expenditure is allowed on a **net basis** after the reduction of interest income, if any, and **up to 30% of EBIDTA.**

The calculation of **EBIDTA would exclude exempt income.**

Exclusion is provided for interest expenditure incurred by **banks, insurance providers, natural persons** undertaking business activity, and any other person as may be determined by the Minister of Finance.

Carry forward is available for the **subsequent 10 years** in the event of any disallowance, and such interest would be included for limit calculation in the next tax period.

Specific interest deduction limitation in Article 31 applies to debts from related parties.

For any inquiries, feel free to contact us

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