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M2K UAE Knowledge Series

Deductions & Determination of Taxable Income

ALERT #5

Preface

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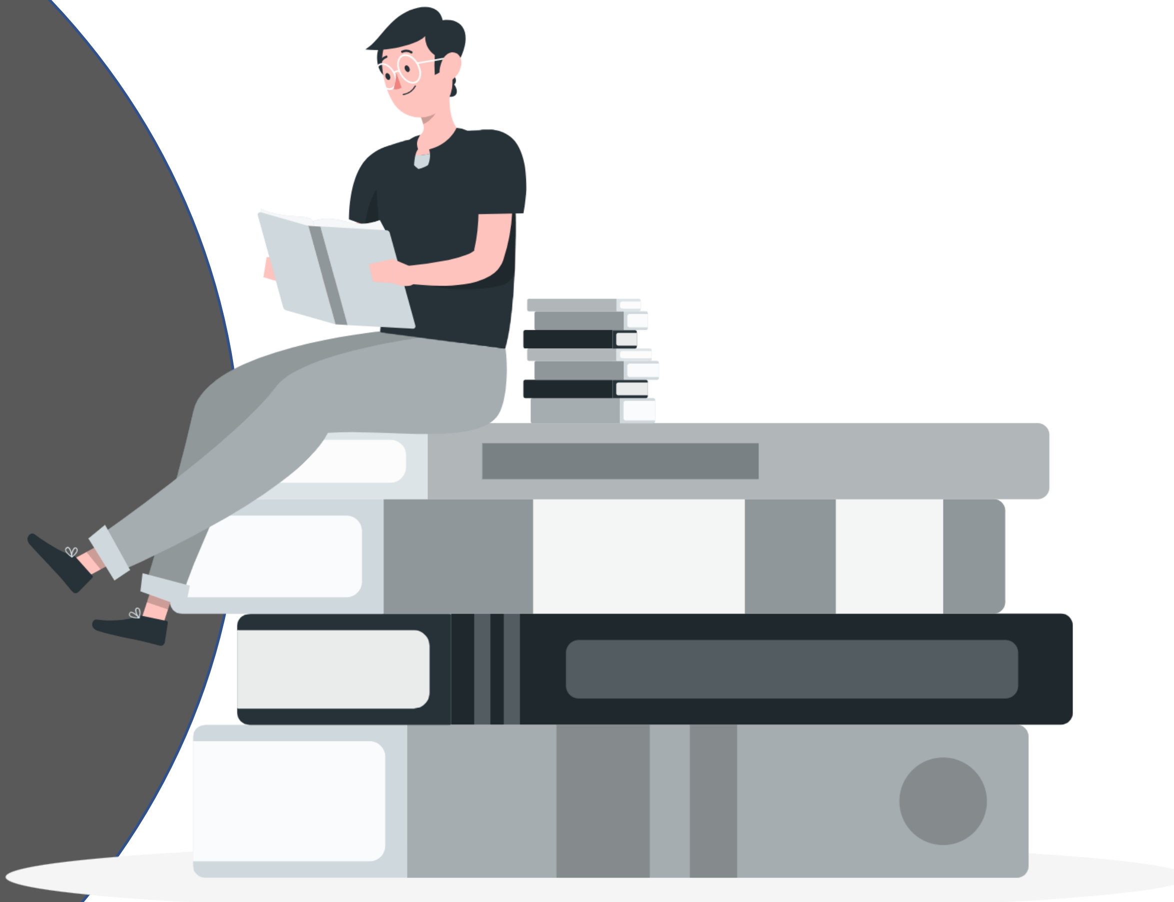
In the previous alert we discussed about the concept of how exempt persons are determined and what the constitution of exempt income is.

The agenda for this alert is to discuss on the provisions of the UAE Corporate Tax on the following topics.

- Determination of taxable income and
- Deductions.



Determination of Taxable Income (1/3)

The taxable income of each taxable person is to be determined separately. The standalone financial statements in accordance with accounted standards accepted in UAE would be used as the basis for this purpose[1]. The adjustments, as applicable to be made to the profits as per the financial statements in order to determine the taxable income are as follows:

- Unrealized gains or losses (refer Slide #4)
- Exempt income (refer series #4)
- Relief for transfer within qualifying group and business restructuring*
- Prescribed deductions/ disallowance of expenses (refer Slide #6)
- Transfer Pricing Adjustments to meet arm's length standard*
- Tax Loss Relief (i.e. set off of carried forward losses etc.) *
- Incentives/ Special reliefs for qualifying business activities, as may be specified in cabinet decision

Further, the Cabinet and finance minister are empowered to issue decisions or specify any other adjustments.

International Financial Reporting Standards (IFRS) is the most frequently used accounting standards in the UAE. Joint Stock Companies and Limited Liability Companies are required to apply IFRS in preparing the periodical and annual accounts under Federal Law on Commercial Companies.

[1] An option is provided to the qualifying tax group to be treated as a single taxable person and the taxable income to be determined on the basis of consolidated financial statements. * To be discussed in upcoming alerts of the Series

Determination of Taxable Income (2/3)

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Unrealized gains or losses (including those on account of foreign exchange)

Any taxable person who prepares his financial statements on accrual basis is provided with an option to consider the gains and losses on the basis of realisation for the purpose of determination of taxable income in respect of:

a) all assets or liabilities subject to fair value or impairment accounting or

b) assets[1] and liabilities[2] held on capital account at the end of a tax period (while unrealized gains or losses are considered in respect of assets held on account of revenue account).

The option provided to the taxpayers to consider gains on realization basis is a welcome step as it aligns the cash outflow in respect of tax to the cash inflow of gains. Taxpayers are relived from the obligation to pay tax on unrealized fair value gains under such option.

- The finance minister is empowered to prescribe cash basis of accounting under specific circumstances. Taxable person can make an application to the tax authorities for change in method of accounting from cash basis to accrual basis, subject to conditions.
- The finance minister is also empowered to prescribe the following:
  - Additional adjustments in computation of taxable income and,
  - Different basis for computation of taxable income for qualifying business activity.
- It has been clarified that the provisions of UAE Corporate Tax Law would prevail over the accounting standards, in case of any conflicts between the two.

[1]Assets held on capital account includes depreciable assets, property plant & equipment, investment property, intangible assets, other non-current assets etc. The same excludes trade assets. [2] Liabilities held on capital account means liabilities that did not arise on account of deductible expenditure, non-current liabilities.

Determination of Taxable Income (3/3)

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Small Business Relief

- An option has been provided to resident persons having gross revenue[1] below AED 3 Million in relevant tax period and previous tax periods to be treated as not having any taxable income, subject to conditions[2]. The said relief for the given threshold would be applicable in respect of all tax periods starting on or after 1st June 2023 and ending before or on 31st December 2026.

- The following provisions of UAE Corporate Tax Law would not be applicable to the taxable person in respect of the tax periods for which small business relief has been opted for:

  - Exempt income,
  - Relief in respect of transfers within qualifying group,
  - Business restructuring relief,
  - Deductions & carry forward of disallowed interest expenditure
  - Carry forward and set-off of losses,
  - Transfer Pricing documentation

- **Small business relief would not be available to the following persons:** (a) Free Zone Persons (b) Members of Multinational Enterprises Groups (MNE Groups)[3]

- It has been provided that artificial separation of business or business activity that exceeds AED 3 Million in any tax period and election for small business relief would be considered to be a case covered under General Anti-Abuse Rules under the Corporate Tax Law and the consequences thereof would follow.

Small business relief' indeed makes UAE an attractive destination for the micro and small businesses and start-ups. The same appears to be aimed at providing relief from no. of compliances under the UAE Corporate Tax Law.

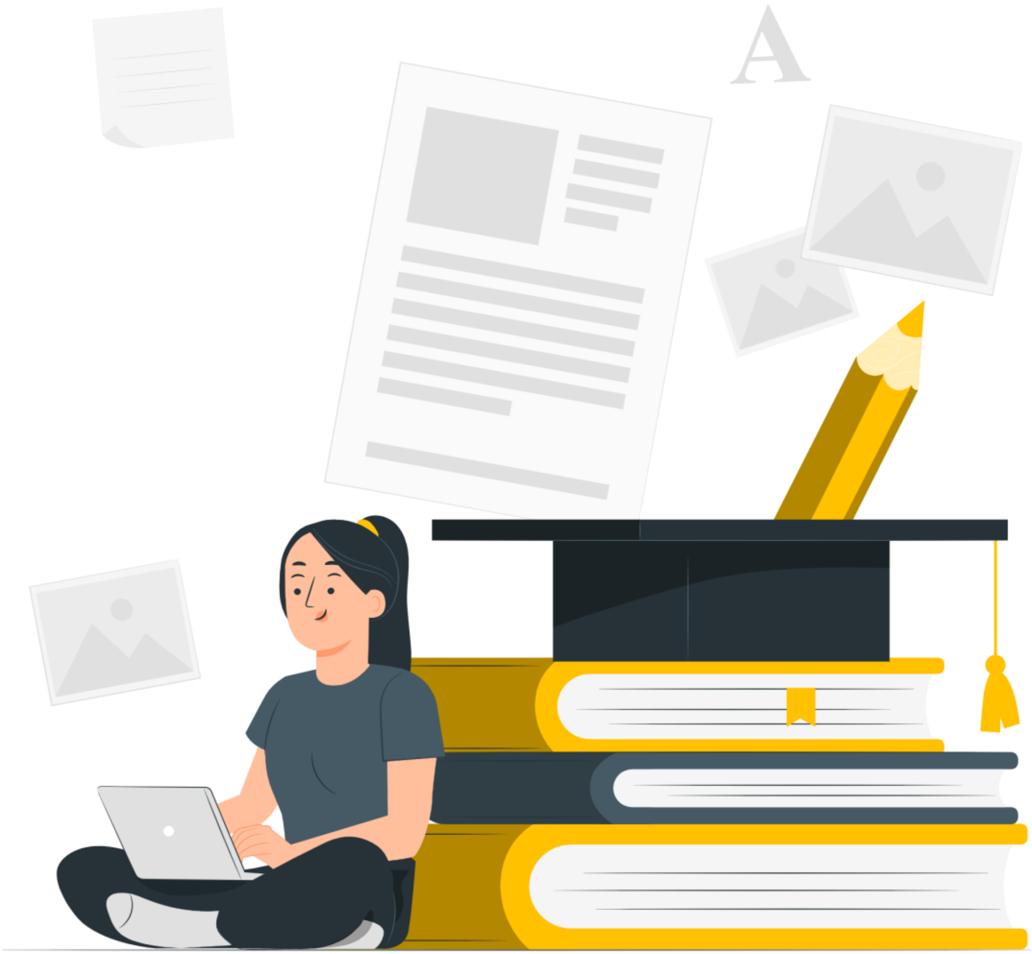
[1]To be determined in accordance with the accounting standards accepted in UAE. [2] Powers have been conferred to tax authorities to call for relevant information and verify the satisfaction f the conditions to be prescribed. [3]Groups of Companies with operations in more than one country having consolidated revenues of more than AED 3.15 billion

Deductions - Deductible Expenditure

Revenue expenditure wholly and exclusively incurred for the **purpose of business are deductible** in computation of taxable income in the year in which such expenditure is incurred. Where common expenditure is incurred for both business and other purposes, deduction is allowed in the following manner:

A **Identifiable part** of proportion of expenditure wholly and exclusively incurred for the purpose of deriving taxable income; and

B **Appropriate proportion of any unidentifiable part** or proportion of expenditure incurred for the purpose of deriving taxable income, to be determined on fair and reasonable basis duly taking into account the facts and circumstances of the business.



Deductions - Expenditure not deductible

Following expenditure are not deductible in computation of taxable income:

- Expenditure and losses, other than those incurred for/ arising from business,
- Expenditure incurred for deriving exempt income.
- Expenditure incurred in respect of entertainment, amusement, or recreation expenditure (incurred for the purpose of business) to the extent of 50% of such expenditure[1]
- Donations, grants or gifts to non-qualifying public benefit entity
- Fines and penalties (other than compensation or damages for breach of contract)
- Bribes or other illicit payments
- Dividends and Profit distributions
- Drawings by the proprietor/ partner of unincorporated partnerships
- UAE Corporate Tax and Income-tax paid in foreign jurisdictions
- Recoverable Input Value Added Tax

Further non-deductible expenditure may be specified in cabinet decision.

The number of disallowance of expenditure, and the adjustments required to be made to the profit as per the accounts in computation of taxable income have been kept very low. This enhances the ease of compliances and reducing the chances for litigations.

[1] This includes meals, accommodation, transportation, admission fee, facilities and equipment for entertainment etc., incurred for receiving / entertaining customers, shareholders, suppliers, other business partners etc.

Deductions – Interest Expenditure (1/2)

The provisions of the UAE Corporate Tax Law in relation to deduction for interest expenditure are enumerated below:

A) Specific Interest Deduction limitation rule:

- Interest expenditure in respect of loan taken *directly or indirectly* from a Related Party for any of the following transaction with a related party would not be deductible in computation of taxable income.
    - Dividend or Profit distribution
    - Reduction, repurchase, reduction or return of share capital
    - Capital Contribution
    - Acquisition of ownership interest
- However, the said limitation for deduction would not be applicable, if the taxable person can demonstrate that the *main purpose* of obtaining the loan and carrying out the transaction is not to gain a Corporate Tax advantage.

Further, no corporate tax advantage is deemed to arise, where the Related Party is subject to UAE Corporate Tax or income-tax in foreign jurisdiction at a tax rate not lower than 9% on the interest income.

Deductions – Interest Expenditure (2/2)

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B) General Interest Deduction limitation rule (‘Thin Capitalization’):

- Deduction in respect of net interest expenditure shall be capped at 30% of the Earnings before Interest, Tax, Depreciation and Amortization (‘EBITDA’) as per accounts of the taxable person. Any exempt income credited in the accounts is to be excluded in Computation of aforesaid EBITDA.

- The amount of interest expenditure disallowed can be carried forward and set-off within a period of 10 years, to the extent that the interest expenditure for the year together with the set-off of carried forward amount does not exceed 30% of EBITDA in the year of set-off. A threshold limit in respect of net interest expenditure below which these provisions would not be applicable may be specified by the finance minister.

- These provisions are not applicable for the below persons: (a) Banks (b) Insurance Providers (c) Natural persons conducting business in UAE. The finance minister may specify any other persons to which these provisions would not be applicable.

Action Plan – 4 (AP 4) of Base Erosion and Profit Shifting (‘BEPS’) recommended six approaches to address the concerns of tax arbitrage and tilt towards funding entities through debt vis-à-vis equity and the characterization and tax treatment of debt and equity. One of the approaches suggested in AP 4 was fixed ratio rule wherein interest deduction is limited to percentage of earnings. The same has been adopted in UAE Corporate Tax Law.

One significant feature to be noted is that these thin capitalization rules are made applicable even in respect of borrowings from third parties, and not just restricted to borrowings from related parties. The same would significantly impact the capital-intensive industries. The set-off of carried forward disallowed interest expenditure again qualifies for set-off, only if the thin capitalization ratio is satisfied in the year of set-off, the effect of which would be that, the set-off would be practically possible where the borrowings and interest thereon keeps reducing over the years (within the period of 10 years from the year when interest was incurred).

Stay tuned for more updates on UAE!

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Please find below the list of completed & upcoming alerts from the series. In case you have missed the previous alerts, click on the hyperlink for the completed alerts to refer the same.

1 Levy Of Corporate Tax

2 Taxation of Non-residents - State Sourced Income

3 Permanent Establishment

4 Exempt Persons & Exempt Income

5 **Deductions & Determination of Taxable Income**

6 Corporate Tax calculations, payments, tax credits & refund

7 Reliefs & Tax losses

8 Tax Group

9 Transfer Pricing & General anti-abusive rule

10 Corporate Tax Compliances & related aspects

11 Corporate Tax - Miscellaneous Provisions

12 India-UAE DTAA Key Provisions

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