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Interest Expense and Tax Deduction Insights in the Gulf Cooperation Council ("GCC") Business Realm

Introduction

Debt and equity are two primary sources of financing. The blend of these funds forms a company's capital structure. The mix of debt and equity depends on factors such as industry risk, ability to raise funds and legal, commercial, and tax considerations. While dividends are paid to equity holders, interest is paid on debt. When a company leans towards debt for its capital structure, it obligates itself to allocate a portion of its earnings to cover interest payments. These interest obligations offer a tax advantage, as they are typically deductible when calculating taxable income. This creates an incentive for companies to opt for debt-based financing over equity, particularly in regions with elevated tax rates.

This article glances into the complex world of interest deductions with a comparative analysis between GCC countries.

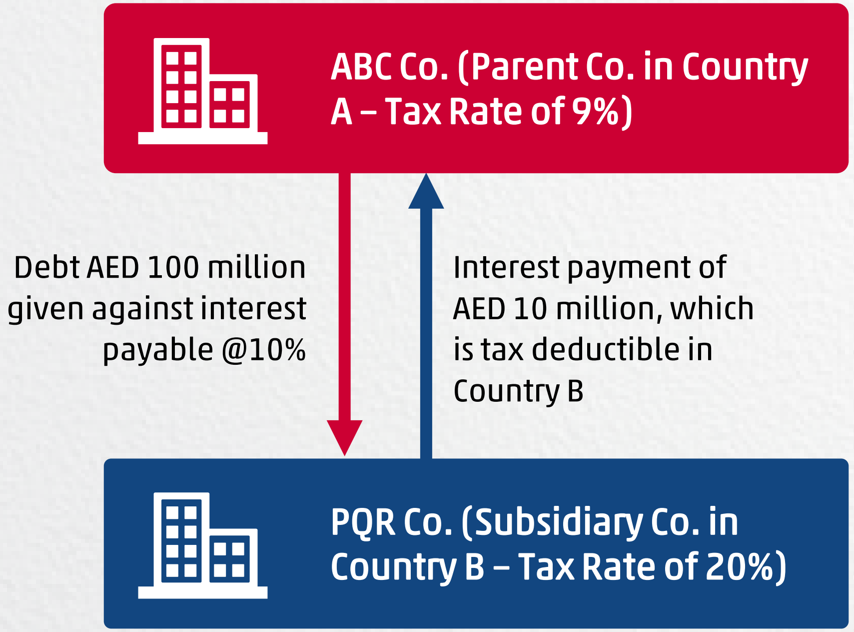
INTEREST DEDUCTION AND THE TAX BENEFIT

Interest payments are generally considered ordinary business expenses and are deducted by the taxpayer to determine the taxable income.

Companies finance the construction of their capital-intensive assets either by raising new equity capital or arranging loans from banks, or by issuing bonds to bondholders. In such cases, the interest expense (also called borrowing cost) incurred on the debt is effectively a cost of the asset, and the matching principle of accounting requires such costs to be capitalised and depreciated over the useful life of the asset. Thus, in such a scenario, interest expense is tax deductible in the form of depreciation over a period of time.

Multinational enterprises ("MNEs") can structure their capital to enable them to claim excessive interest payments and achieve higher tax savings at a group level by relying on higher debt compared to equity (in technical terms this is commonly referred to as "thin capitalisation"). Let us decode this with the help of an example

Group tax savings using debt financing



To prevent MNEs from the cross-border shifting of profits through excessive interest payments and protect a country's tax base, the Organization for Economic Cooperation and Development ("OECD") has made recommendations for best practices in its base erosion and profit shifting ("BEPS") Action Plan 4. Following the same, many countries have introduced either thin capitalisation rules or limitations on interest deduction rules in their tax laws.

What is the thin capitalisation rule/ debt restriction?

It means determining the maximum amount of debt on which interest deduction should be permissible. For example, Canadian law provides that interest on any debt that is beyond the 1.5:1 debt-to-equity ratio will not be deductible. According to the Egyptian Income Tax Law, the thin-cap ratio in Egypt is currently 4:1. Accordingly, the law disallows the deductibility of debit interests of Egyptian companies if such loans and advances are in excess of fourfold the equity average.

What does a limitation of interest deduction/interest restriction involve?

It involves determining the maximum amount of interest that can be deducted. This is generally determined as a ratio of interest paid to another variable.

For example, Italy caps the interest deductibility to 30% of earnings before interest, taxes, depreciation and amortization ("EBITDA"). In Kuwait, interest paid abroad is disallowed as a deduction against income unless a specified condition is satisfied. Similarly, Saudi Arabia and UAE also have interest limitation clauses in their income tax law.

COMPARATIVE ANALYSIS BETWEEN THE GCC MEMBER COUNTRIES REGARDING THE PROVISIONS RELATING TO INTEREST DEDUCTIONS.

Particulars	Interest Deduction Rule	Law Provisions
UAE	There are no thin capitalisation rules but an interest deduction limitation clause is introduced in corporate tax (“CT”) law.	• UAE CT law has general and specific interest deduction limitation rules. Under the general rules, businesses can deduct the net interest expenditure up to the higher of either 30 per cent of their adjusted EBITDA (earnings before interest, taxes, depreciation, and amortisation) or a predetermined “safe harbour” amount of AED12 million. Any financial returns on a financial asset or liability that comprise interest or payments economically equivalent to interest will be considered for the purpose of determining the maximum amount of interest deductible e.g. guarantee fees, interest on Islamic financial instruments, interest components on forward/future contracts/derivatives, foreign exchange gains and losses accruing from interest, even capitalised interest etc. • Interest expenses on a loan from a related party are not deductible for certain transactions such as dividend payments, buybacks of shares, acquisitions of ownership interest etc., unless 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 or the interest income is taxed @≥ 9%. • Net interest expenditure that exceeds the maximum deduction limit may be carried forward and claimed in the subsequent ten tax periods.
Bahrain	There are no thin capitalisation or limitation of interest deduction rules in Bahrain.	Since currently there is no corporate tax system in Bahrain, interest deduction provisions are not applicable. However, the income tax law in Bahrain requires that taxable profits be calculated using generally accepted accounting principles (“GAAP”).
Kuwait	There are no thin capitalisation or interest deduction limitation rules in Kuwait. However, under local law, there are certain conditions for interest expense deduction.	• Interest paid by a company is allowed as an expense, provided it is fully supported, paid to a financial institution, and related to operations undertaken in Kuwait. However, the tax law provides the authorities with the right to determine the proper tax treatment on a case-by-case basis (if required). • Further, interest expense is capitalised and added to the asset value if such loans are utilised to finance the company's capital operations. • All interest charged on the head office current account by the company’s branch in Kuwait (either directly or through a Kuwaiti agent) is disallowed as a deduction against income. • Interest paid abroad is disallowed unless the taxpayer proves that the interest relates to bank loans or facilities used to finance its operations in Kuwait.

COMPARATIVE ANALYSIS BETWEEN THE GCC MEMBER COUNTRIES REGARDING THE PROVISIONS RELATING TO INTEREST DEDUCTIONS.

Particulars	Interest Deduction Rule	Law Provisions
Oman	The thin capitalisation rule applies. There is no interest deduction limitation clause.	• Interest expense is allowed for loans from unrelated parties or banks. • If the debt-to-equity ratio exceeds 2:1 in the case of related-party debt, interest on the excess debt is not deductible for tax purposes. This rule does not apply to banks and insurance companies, permanent establishment ("PEs") of foreign companies, or proprietary (Omani-owned) establishments.
Qatar	The thin capitalisation rule applies. There is no interest deduction limitation clause.	• Interest on loans used for the purpose of the taxpayer's activity is tax deductible, except where the loan is between a Qatar branch and its head office or a party related to the head office. • Thin capitalisation rules under the State of Qatar tax regime limit the tax deductibility of interest payments where the taxpayer's debt-to-equity ratio exceeds 3:1.
Saudi Arabia	There are no thin capitalisation rules, but an interest deduction limitation provision is applicable.	• An interest deduction is limited to the lower of: (i) the actual interest expense; or (ii) interest income plus 50% of taxable income (excluding interest income and interest expense). • A Saudi company may deduct interest payments to affiliates but not to the head office, provided that the debt and interest rate are at arm's length and that the interest deductibility formula is met. A Saudi company may be financed with minimum capital, and there is no limit on the amount of debt that may be used.

While the interest expense deduction may be restricted for the payer, the interest income of the payee is usually taxable as regular income at applicable tax rates in the country. Further, withholding tax on interest payments applies as follows:

- No withholding tax is applicable in the case of Bahrain and Kuwait;
- 0% withholding tax is applicable in UAE and Oman;
- In Qatar, the withholding tax @5% applies to interest payments;
- In Saudi Arabia, interest payment to residents is subject to 0% withholding tax, whereas interest payment to non-residents is subject to 5% withholding tax.

The GCC countries have entered into tax treaties (Double Tax Treaties ("DTTs")) with several countries in order to avoid double taxation. These treaties provide that the withholding tax rates of the source country apply on investment returns (such as dividends, interest and royalties) unless the DTT rate is lower. Thus when applying the withholding tax rate, it is important to check the withholding tax rate applicable under DTTs with respective countries.

CONCLUDING REMARKS

Global trade and economic growth depend on loans and the free flow of credit. Generally, the borrower may deduct interest payments from both taxable income and financial statement income since they are regular business expenditures. The lender is frequently required to pay taxes on the interest revenue.

Large corporates utilise shareholder and intra-group loans to manage their liquidity requirements and facilitate cash transfers between entities within their groups. These loans are usually granted with no security, minimal documentation and flexible terms. In these cases, transfer-pricing provisions play a crucial role in the context of interest deductions in international transactions as they provide transparency. The aim is to prevent companies from artificially shifting profits by manipulating interest rates on internal loans between associated companies.

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Nimish Goel
Partner

K Venkatachalam
Partner

Hany Elnaggar
Associate Partner

Kapil Bhatnagar
Associate Partner

Harpal Chudasama
Director

Mahmoud Fathy
Manager

Contact us

Dhruva Consultants

207, Emaar Square, Building 4,
PO Box 127165, Dubai, UAE

1905, Addax Tower, City of Lights,
Al Reem Island, Abu Dhabi, UAE

Email: corporatetax@dhruvaadvisors.com

Website: https://www.wts-dhruva.com/