Tax Flash News – Corporate Tax Guide on the Determination of Taxable Income

The United Arab Emirates ('UAE') Federal Tax Authority ('FTA') has issued the Corporate Tax ('CT') Guide on the Determination of Taxable Income ('the Guide') with the intent of providing general guidance to taxpayers for determining their Taxable Income and calculating Corporate Tax payable under the Federal Decree-Law No. 47 of 2022 on Taxation of Corporations and Businesses ('UAE CT Law').

This comprehensive Guide covers a range of relevant topics and includes practical case studies that explore various adjustments to accounting income for determining Taxable Income of a Taxable Person. Some specific insights provided by the FTA have been disclosed in previously published Guides (e.g. Qualifying Free Zone Persons, Exempt Income, Tax Grouping, Accounting Standards etc.).

Key highlights of concepts discussed in the Guide are summarized below:

1. General interest deduction limitation rule:

   While the clarifications provided in the Guide are similar to the provisions in Articles 30 and 31 of the UAE CT Law and Ministerial Decision ('MD') No. 126 of 2023, the Guide includes an illustrative computation of net interest expenditure and adjusted EBITDA for the purpose of calculating the limitation on interest deduction. In this regard, the Guide examines different scenarios for determining the deductibility and calculating the limitation on interest expense deductions.

2. Specific interest deduction limitation rule on loans obtained from related parties:

   The Guide specifies that interest expenditure on loans obtained from related parties for specific transactions (e.g. dividend distribution, capital contribution, a redemption, repurchase, reduction or return of share capital, etc.) is generally not deductible, unless it can be demonstrated that the loan was not primarily for obtaining a CT advantage. However, if the related party booking the interest revenue is subject to CT or a tax of similar nature in a foreign country, at a rate of at least 9% on the interest income, then no CT advantage will be deemed to have arisen.

3. Tax loss relief, transfer and carry forward of tax losses and limitation on tax loss carried forward

   The Guide presents several case studies to illustrate the sequence for utilizing or offsetting tax losses incurred by a Taxable Person during a Tax Period. These case studies also analyze the interaction between the utilization of tax losses by the Taxable Person, transfer of tax losses among Qualifying Group entities and offset of the unutilized tax losses carried forward. One of the case studies explains the impact of a change in the shareholding (in excess of 50%) combined with a change in the business of the Taxable Person, resulting in the tax losses being forfeited in the Tax Period where such changes occur.

4. Treatment of creation and reversal of provisions

   Provisions for expenses and provision for bad debts created or bad debts written off, in accordance with the accounting standards (i.e. International Financial and Reporting Standards ('IFRS') or IFRS for Small and Medium Entities) would be allowed as deductible expenditure, subject to other deductibility conditions. For instance, provision for any fines, penalties or illegal payments shall not be deductible. Reversal of provisions for expenses or bad debts recovered in subsequent years, shall be treated as part of Taxable Income, corresponding to the accounting treatment in the income statement, irrespective of whether the provisions were created or recorded before the applicability of CT to the Taxable Person.

5. Attribution of profits to Permanent Establishment ('PE') under the 2-step approach

   Where the activities of a Non-Resident Person (foreign company's head office) result in the creation of a PE in the UAE, either under the fixed place of business or dependent agency test, such PE must be treated as a separate entity. The head office is required to attribute the appropriate amount of income and associated costs to its PE in accordance with the arm's length standard under the 2-step which is provided in the UAE Transfer Pricing ('TP') Guide, CT Guide and also in the Free Zone Persons Guide. The 2-step approach requires conducting a functional analysis and ensuring the arrangements between the head office and the PE follow the arm's length approach. This approach must be pragmatic and needs to be included by the UAE Taxable Person in the TP documentation prepared for each period.

Some important deductible and non-deductible expenses illustrated in an explanatory manner in the Guide are as follows:

Category	Deductible Expenses	Non-deductible Expenses
Entertainment Expenses	• **Entertainment for employees**, such as staff parties, off-site events/away-days or rewards for meeting performance targets, etc. • **Incidental expenses**, for example refreshments provided in a business meeting during an office setting or retailer providing complimentary refreshments to potential customers. • Taxpayers who are in the business of **commercial hospitality** and provide entertainment in the ordinary course of business, such as hotels providing mid-week promotions, or in-flight entertainment by airlines. • **Marketing and advertising expenditure** such as a restaurant giving a free meal to a food critic, a spa providing free entry to an influencer, a trial run of hotel facilities provided to a potential bulk buyer of the product, etc. • Purchasing a booth at a trade show to display the company's new product line.	The following expenditure is **completely disallowed** from a CT standpoint: • Expenditure relating family members' private events (e.g. weddings) who happen to also be staff. • Entertainment expenses for shareholders' family members. The following are subject to **50% disallowance**: • Entertainment expenses for business partners. • Refreshments provided at a restaurant. • Complimentary stay provided to business partners at hotels by a hospitality company. • Discretionary costs of providing hospitality at an event (such as meals, a musical performance, or accommodation). • Cost of taking a group of clients to a sporting event and providing them with tickets, meals, and drinks in a corporate box.
Employee costs	• Reimbursement of the increased associated costs for such employees required to exclusively work from home (such as home office set up, and part of the utility bills). • Salary or bonus paid to directors, officers, or owners of the Taxable Person, insofar as this salary corresponds with the Market Value rates for such services rendered applying arm's length standard (as this fall under the category of payments made to Connected Persons).	• Shared employee costs to the extent they do not correspond to the Taxable Person's business such as time-based apportionment of salary cost of employees working for different group companies. • Expense incurred for a private event, such as a wedding of a family member who happens to be an employee.
Payments to Connected Persons	• Any amounts paid to the Executive Director as an employee, assuming the payments to directors-shareholders are at arm's length.	

Expenditure which is capital in nature	• In case the accounting policy provides that certain low-value capital items are not to be capitalized, despite having enduring benefits (e.g. useful life of two years) and are directly debited in the income statement for an specific Tax Period, then the accounting treatment should be followed.	• Amount of the depreciation expense relating to the capitalized amount of professional fees paid to a connected person that is not at arm's length, despite being capitalized in accordance with IFRS or IFRS for SMEs.
Pre-incorporation expenses	• Pre-incorporation expenses incurred by shareholders in relation to professional fees, registration fees etc. to incorporate a company that are reimbursed to the shareholders and in accordance with IFRS are expensed in its first Financial Year (i.e. the current Tax Period).	
Expenses relating to Exempt Income		• Due diligence fees or commission for acquiring shares in Participating Interests, the income received from which is Exempt Income.
Other Expenses	• Local taxes that are not in the nature of CT, such as municipal and property taxes. • Zakat paid to a Qualifying Public Benefit Entity. • Head office expenses incurred by an overseas entity that are allocated to the overseas entity's UAE operations.	• Emirate-level taxes are not allowed as a deduction under CT. • Zakat paid to an entity other than a Qualifying Public Benefit Entity.

This list is illustrative and not exhaustive, providing examples rather than a complete inventory of the case studies published by the FTA in this Guide.

Key takeaways

- Accounting standards/policies adopted by the Taxable Person for preparing financial statements and the treatment of expenses in the income statement prepared in accordance with IFRS/IFRS for SMEs, as applicable, **would generally be followed** for the purpose of computing Taxable Income.

- Any fines/penalties for non-compliance that are punitive in nature or any payments for **infraction/breach of any laws**, rules, or regulations, will not be deductible for CT purposes even if they are incurred in the normal course of Business.

- Depreciation/amortization would be deductible only if they correspond to capital expenditure that would have been deductible if it was not capital in nature. For instance, if any non-deductible fines/penalties are capitalized as part of the cost-base of an asset, depreciation to the extent it relates to the fines/penalties will not be deductible.

- All UAE businesses should ensure that transactions with their related parties and connected persons **adhere to the arm's length standard**. In addition, UAE branches or PEs of non-resident persons must conduct their arrangements and dealings with their head offices in accordance with the arm's length principle.

- All expenses in order to be deductible expenses must be incurred for the purpose of the Taxable Person's business only. Limitation on the deductions of expenses such as entertainment expenditure or interest expenditure would not make non-business expenses deductible.

- Based on the illustrative list of the adjustments relevant for determining Taxable Income published in the Guide, it is expected that information about **incentives and special reliefs for a Qualifying Business Activity** as referred to in Article 20(2)(g) of the CT Law is expected to be published through implementation decisions in the upcoming months.

The Guide provides comprehensive direction on the computation mechanisms and indicative checklists that can be followed by taxpayers to efficiently apply the tax rules in UAE. The Guide should be read in conjunction with the Corporate Tax Law, the implementing decisions and other relevant guidance published by the FTA.

Next steps

All Taxable Persons should ascertain their potential CT liability relevant for the first Tax Period by referring to the relevant case studies published this Guide.

KPMG has a dedicated team to help your business understand the qualitative and quantitative impact of corporate tax on your business in the UAE.

Contact us

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