

UAE CT: “Determination of Taxable Income” Guide

Key Takeaways



August 2024



“Determination of Taxable Income” Guide

The Federal Tax Authority (FTA) has released a Corporate Tax (“CT”) Guide on Determination of Taxable Income (“TI”). This Guide serves as a significant resource, providing clarifications and additional insights on various important topics calculation of the TI. Here is our **overview of the guide** followed by our **key takeaways**.

Overview of the Guide

- The Guide seeks to provide general guidance to Taxable Persons for determining their TI and calculating their CT Payable under the CT Law, including the following:
 - adjustments required to be made to Accounting Income (“AI”) for determining TI, and
 - adjustments required to be made to TI for calculating the CT Payable.
- The Guide is also applicable to a Qualifying Free Zone Person (“QFZP”) where relevant.
- The Guide includes **9 detailed case studies** to illustrate the key concepts for determination of TI. They provide specific fact patterns, illustrative extracts of financial information from the Financial Statements, followed by tax adjustment tables, and explanatory notes with calculations for taxable/non-taxable and deductible/non-deductible items. It is recommended that taxpayers read and understand the implications of each of them, since they cover:
 1. **Deductible and non-deductible expenditure** - This case study covers the adjustments to be made to AI relating to deductible and non-deductible expenditure (excluding Interest deduction limitation rules).
 2. **Interest expenditure** - This case study covers the adjustments to be made to AI relating to Interest expenditure. It covers the applicability of the General and Specific Interest Deduction Limitation Rules (i.e. deductible and non-deductible Interest expenditure and the treatment of disallowed/unutilised Net Interest Expenditure).
 3. **Tax Loss relief** - This case study covers the adjustments to be made to AI relating to Tax Loss relief and the treatment of unutilised Tax Losses.
 4. **Interest expenditure and Tax Loss relief** - This case study covers the adjustments to be made to AI in a situation where there is both unutilised/carried forward Net Interest Expenditure and Tax Losses.
 5. **Transfer of Tax Loss and limitation on Tax Loss carried forward** - This case study covers the application of provisions relating to the transfer of a Tax Loss and the limitation on the use of Tax Loss carried forward.
 6. **Cash Basis of Accounting** - This case study covers the determination of TI and calculation of CT Payable in the case of a Taxable Person having Revenue equal to or less than AED 3 million and applying the Cash Basis of Accounting.
 7. **Unrealised gains and losses, Exempt Income** - This case study covers the adjustments to be made to AI for unrealised gains or losses, and for Exempt Income (such as Dividends, income from Participating Interest) including expenditure incurred in earning Exempt Income.
 8. **Foreign Permanent Establishment** - This case study covers the adjustments to be made to TI in relation to the Foreign Permanent Establishment (“PE”) exemption.
 9. **Non-Resident Person conducting Business in the UAE through a Permanent Establishment** - This case study covers the determination of TI and calculation of CT Payable in the case of a Non-Resident Person operating in the UAE through a PE.

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Key takeaways

- The Guide reiterates that the UAE CT legislation may have **incentives and special reliefs for a Qualifying Business Activity (Article 20(2)g in CT Law)** to be introduced via relevant Cabinet Decisions. We will wait to see what reliefs are introduced, but this could be potentially relevant and beneficial to a number of taxpayers, so updates should be monitored.
- The Guide clarifies that **local taxes that are not in the nature of CT**, such as municipal and property taxes, will be tax deductible.
- **Tax Loss relief**, if any available, should be applied on the TI, i.e. the tax adjusted AI. After that, the applicable tax rates (i.e. 0% and 9%) are to be applied to the tax loss adjusted TI.
- The **Revenue threshold of AED 50 million** to prepare audited Financial Statements must be considered in line with the arm's length standard. For companies incorporated in the UAE (or operating in the UAE through a PE situated in the UAE), the audit must be performed by a **UAE-registered auditor**.
- The Guide clarifies that if the Taxable Person does not make the **election to apply the realisation basis** for unrealised gains/losses in the first Tax Period, then this will be considered an irrevocable election. It is therefore important for taxpayers to determine their preferred election position as early as possible.
- **Employee costs** are generally considered to be wholly and exclusively incurred for Business purposes provided they are not excessive and meet the arm's length standard (where employees are Related Parties or Connected Persons). **Employee benefits** other than cash salaries incurred for the wealth and benefit of the employees to retain or reward them could also be deducted in full for CT purposes; the guide specifically mentions medical insurance, private car use, flight allowance for spouses and children, personal weekend travel, entertainment, etc. However, **private pension fund** unpaid contributions or excessive contributions (>15% of the employee's total remuneration) are not tax deductible.
- The Guide explains that **expenses incurred in relation to more than one purpose** (e.g. for Business purposes and in relation to Exempt Income) should be allocated based on the fair and reasonable basis. The **appropriate allocation key** will depend on the nature of the expense and the contribution that it makes to each income component. In many cases, an allocation that prorates expenses based on Revenue will be considered as a reasonable allocation, however, this may not always be the most appropriate allocation key. The allocation key should also be used consistently for each Tax Period, unless there is a change in fact pattern which justifies a change. If the expenditure cannot be apportioned on a fair and reasonable basis, **it will not be allowed as a deduction for CT purposes**.
- **Where non-deductible expenses are capitalised, any depreciation associated with these capitalised expenses will not be deductible for CT purposes**. For example if the cost of an asset includes capitalised expenses related to government fines or non-arm's length payments to Related Parties, the proportion of depreciation related to these costs is not deductible for CT purposes.
- **Pre-incorporation expenses** incurred before the Business is officially incorporated or set-up may be allowed if booked in the accounts and not claimed for tax deduction by another Taxable Person. Similarly, **pre-trading expenses**, including pre-launch and pre-commercial phase expenses, will be allowed for a tax deduction, even if the Business has not started generating Revenue in the Tax Period in which the expense is incurred.
- The Guide confirms that where **provisions were recorded before a Taxable Person's first Tax Period** and then reversed/recovered after the Person becomes subject to CT, the reversal/recovery is taxable when the credit is recorded in the Financial Statements. This also applies to recovery of bad debts. Taxpayers should therefore review their existing provision and bad debt profile carefully.

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- Per the Guide, for CT purposes the accounting classification of a particular expense is not relevant when considering whether such an expense is **entertainment expenditure**. The Guide provides the following grouping of expenses for CT purposes:
 - (i) **Entertainment for employees** are generally fully deductible. Examples are staff parties, off-site events/away-days (which may include spouses and children) or rewards for meeting performance targets;
 - (ii) **Incidental expenses** for business meetings, food and refreshments in office, complimentary drinks to customers are also generally fully deductible;
 - (iii) **Commercial hospitality**. Where a Taxable Person provides commercial hospitality as part of its Business or Business Activity, for example in-flight entertainment, hotel's packages or mid-week promotions, etc, this would not be considered entertainment expenditure and can be claimed as a deduction.
 - (iv) **Marketing or advertising**. The 50% deduction restriction rule does not apply to other marketing expenditure, such as advertising, promotions, attending trade shows or direct marketing campaigns. Nevertheless, typically discretionary costs of providing hospitality at the event such as meals, a musical performance or accommodation will be subject to the 50% restriction for entertainment expenditure. While marketing related sponsorship costs (for example, sponsoring an event) will be deductible, any benefits received as part of that sponsorship used to entertain business partners and/or customers, such as tickets to a sporting event, shall be subject to the 50% limit.
- The Guide reiterates that the following will not be considered while calculating the **Net Interest Expenditure** for the purposes of the General Interest Deduction Limitation Rule (“GIDLR”):
 - Interest expenditure that is disallowed under any other provisions of the CT Law, for example, the Specific Interest Deduction Limitation Rule (“SIDLR”) or non-arm's length amounts
 - Interest income or Interest expenditure related to grandfathered debts (i.e. prior to 9 December 2022)
 - Interest income and Interest expenditure in relation to Qualifying Infrastructure Projects
- Taxable Income (even if negative) before the GIDLR and Tax Loss relief is required to be increased by the following, to arrive at the “**adjusted EBITDA**” for the purposes of GIDLR:
 - Net Interest Expenditure for the relevant Tax Period
 - depreciation and amortisation expenditure tax deducted for the relevant Tax Period
 - any Interest income or expenditure relating to historical financial assets or liabilities held prior to 9 December 2022
 - any Interest income or Interest expenditure in relation to Qualifying Infrastructure Projects
- For the interest tax deduction calculation, the Guide has an example where interest expense on **trade payables** and interest income on **trade receivables** are part of the Net Interest Expenditure calculation.
- With respect to **Tax Losses**, the Guide envisages that a Taxable Person must first offset the Tax Loss against its own TI before such losses can be transferred to another Taxable Person and/or carried forward to subsequent Tax Periods.
- The Guide reiterates that the CT liability could first be reduced by a credit for **Withholding Tax (“WHT”)** incurred inside UAE (i.e. by a non-resident) and then by a credit for **Foreign Tax (“FTC”)** incurred outside the UAE. UAE WHT is not currently applicable until a Cabinet Decision specifying the categories of income subject to WHT is issued (not at the date of this alert). The amount of FTC is the lower of:
 - (i) The actual amount of tax paid on foreign source income in the foreign jurisdiction.
 - (ii) The amount of the CT due in the UAE on the **net foreign source income**.





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- There is an example in the Guide for how **impairment gains or losses** should be treated in relation to shares in a company which is a Participating Interest. Irrespective of whether an election is made for unrealised gains/losses under Article 20(3) or not, the end result would be a **tax adjustment for impairment gains/losses from a Participating Interest (non-deduction of accounting losses and non-taxation of accounting gains)**.
- The Guide reiterates that **expenditure incurred in relation to deriving Exempt Income** is not deductible when determining TI.
- For **Related Party transactions**, there is an example in the Guide where a transfer pricing adjustment is applied to reduce the TI of a Foreign PE of a UAE based Company A, with a corresponding increase of TI of Company B (a UAE based Related Party of Company A). The Foreign PE exemption is also applied by Company A, which effectively results in additional CT for Company B, but no additional tax saving for Company B due to the exemption. It is important to know the overall impact of **transfer pricing adjustments** on a group.
- For **UAE PE of a foreign company**, there is an example in the Guide where TI allocated to the PE includes different types of UAE income of a foreign company:
 - Revenue from a 10-month **construction contract** performed in the UAE (no Double Tax Treaty), with additional head office costs allocated to the PE. Also, **gifts to business partners** are non-deductible;
 - Income from immovable property in the UAE (**nexus**);
 - Exempt Income: **Dividend** from a UAE juridical person that is a Resident Person.

Next steps

- Taxpayers need to carefully consider the relevance and application of these guidelines to their business.
- The Guide helps to reinforce that taxpayers need to adopt a structured approach to the calculation of TI and CT payable. The tax team should take into the account the complexity of potential multiple tax adjustments to the accounting income. The data required for the adjustments may need to be obtained from several sources, for example marketing and entertainment expense details may need to come from business development or commercial teams, and interest expense details may need to come from treasury teams, etc.
- In light of the potential complexity and number of business functions involved, taxpayers should consider implementing and documenting tax policies and procedures for the benefit of all internal and external stakeholders, including the FTA (should these ever be required to be produced to support the filing positions adopted).
- The financial year end for the majority of taxpayers will be 31 December 2024 (although some taxpayers may have earlier periods). It is important to have the correct calculation of CT and related deferred taxes for financial reporting purposes, so taxpayers will need to consider the implications of the Guide well in advance of starting the return filing process.
- For further assistance, you can reach us at CT.UAE@pwc.com.

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