

MMJS Corporate Tax Alert

Interest Deduction Limitation Rules for the Purposes of Taxation of Corporations and Businesses

Federal Decree Law No. 47 of 2022 on the Taxation of Corporations and Businesses (UAE CT Law) generally allows interest expense as a deduction while determining the taxable income during relevant tax period. However, the provisions of Articles 30 and 31 under the UAE CT Law provide for limitation rules for interest expense deduction subject to certain conditions. Also, the Ministry of Finance (MOF) has previously issued Ministerial Decision No. 126 of 2023 (MD 126), which outlined additional provisions pertaining to the general interest deduction limitation rules under Article 30 of UAE CT Law.

The Federal Tax Authority (FTA) in the UAE has recently released a detailed Guide on Interest Deduction Limitation Rules CTGDTII (Guide) dated 07 April 2025 to provide further clarifications and guidance on the relevant conditions and mechanism of computing the deduction limitation.

We have captured certain key highlights of the guidance/ clarifications provided under the Guide:

HIGHLIGHTS OF THE GUIDE:

Scope of the term 'Interest'

- ▶ The Guide provides a detailed explanation of the scope of '**Interest**' as defined under Article 1 of MD 126. The Guide explains that Interest refers to any amount accrued or paid for the use of money or credit, including discounts/ premiums on debt instruments and profit/ mark-up paid in respect of an Islamic financial instrument and other payments economically equivalent to interest (including any amounts accrued or paid for use of money or credit).
- ▶ The Guide clarifies that the scope of the term 'interest' should be considered based on the definition provided under MD 126, rather than merely considering the definitions under IFRS/ IFRS for SMEs.
- ▶ Regarding payments made in respect of Islamic financial instruments (such as Mudarabah, Ijara, Sukuk, Salam contract, Istisna, etc.) the Guide clarifies that profit or mark-up component of such payments made could be treated as interest for the purpose of interest deduction limitation rules. Further, the Guide clarifies that any Islamic financial instrument (or a combination arrangements forming part of the same instrument) that is treated as ownership interest under the AAOIFI (i.e. Accounting Standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions) should be considered as not having any interest element.

Specifically, in relation to Islamic Financial Instruments, it is clarified that determination/ characterisation of any payments as 'interest' should to be aligned with treatment as per IFRS.

- ▶ For determining whether a payment made by a taxable person is economically equivalent to interest, the Guide states that the same should be assessed based on whether the economic substance of such payment provides any financial returns similar to the nature of debt or equity. If the same provides returns in the nature of a debt instrument, the payment should be treated as interest expense.
- ▶ In respect of returns from investments in collective investment schemes (CIS) that primarily invest in cash and cash equivalents (i.e. more than 50% of their overall portfolio), such income should be treated as interest in entirety, irrespective of the underlying nature of income derived by the CIS. Thus, even the income from the investment made by such CIS in equities is not considered to be profit distribution / dividend income (even if the income in respect of the investment in equities is more than the investment in respect of cash or cash equivalents in a given Tax Period) and should be treated as interest.

- ▶ The Guide has provided further clarifications regarding interest component of non-financing leases (operating leases). The Guide states that operating leases can be considered to have finance elements which will be treated as interest for the purpose of interest deduction limitation rules. For instance, the finance element of right-of-use assets for the lessees will be treated as interest expense. Even in case of lessors, the Guide has provided the following formula to calculate the finance element (i.e., interest income) of operating lease payments **(irrespective of there being no finance element for accounting purposes)**:

$$\text{Finance Element of Non-Finance Lease Payment} = \frac{\text{Lease Payment} * \text{Total Finance Elements of the Lease}}{\text{Total Cost of the Lease}}$$

Effectively, the total finance element of the lease over the tenure of the lease = **Total cost of the lease – (Initial value of the leased asset – Expected depreciated value at the end of the lease period)**

- ▶ As per Article 6 of MD 126, all foreign exchange movements pertaining to interest or other similar payments should also be included as interest in the net interest expenditure calculation. The Guide has clarified that any such movements on the principal portion of the loan should not be classified as interest, as the same is not accrued from the element of interest.
- ▶ Another aspect clarified by the Guide is the treatment of capitalised interest expenditure when determining the portion of deductible expenditure for a relevant period. To calculate the net interest expenditure, the capitalised interest should be amortized over the useful life of the relevant asset, with only the portion of such interest pertaining to the relevant tax period being included in the calculation. Further, for calculating 30% of EBITDA for the purpose of determining the deductible interest amount, the taxable person is required to subtract the portion of capitalised interest from the depreciation amount in this calculation, as the same is essentially a portion of depreciation which is rather treated as interest.
- ▶ In cases of charges for late payment (or non-payment) of any statutory dues, the Guide clarifies that such expenses should not be considered as interest and should be disallowed as fine/ penalty, regardless of the mechanism of calculation of such amount.

In respect of additional charges payable on overdue commercial invoices, such additional expense should be considered as interest expense, unless such charges are specified as fine or penalty in a relevant contract.

- ▶ Any interest component of a derivative contract is considered to be Interest. The “interest component” would follow the interest or other financing amount or gain or loss taken to the income statement under IFRS (or IFRS for SMEs).

Costs directly related to entering into derivative contracts, such as fees, are also treated as interest expenditure.

- ▶ Where a debt instrument is disposed, sold or transferred, it may result in a gain or loss. Such gain or loss is also considered as interest to the extent it is treated as interest or other financing amount under IFRS (or IFRS for SMEs).

Carry forward and set-off of unutilised net interest expenditure

- ▶ As per UAE CT Law, any unutilised net interest expenditure incurred during a relevant tax period can be carried forward and utilized in the subsequent ten tax periods. The Guide clarifies that the same should be utilized on **first in, first out (FIFO) basis**, i.e., in the order in which such net interest expenses have been incurred in the previous tax periods.
- ▶ If a taxable person having gross revenue less than AED 3m claims Small Business Relief (SBR) during a tax period, any disallowed net interest expense incurred in a previous tax period(s) can be carried forward and utilized during a subsequent period when such an election is not made.
- ▶ The Guide states that, in cases where a **non-resident juridical person** (such as Permanent Establishment in the UAE) has ceased to be a taxable person and has de-registered from UAE CT Law, any unutilized net interest expenses will be **forfeited** once de-registered and the same **cannot be carried forward** by such person in case it becomes a taxable person again through another PE or nexus in a subsequent period.
- ▶ The Guide has also highlighted that in cases where the taxable person uses cash basis of accounting, any interest expenditure should be considered for the general interest deduction limitation rules only when the same is **paid** or **received**.

Grandfathered debts/ historical liabilities for exception from general interest deduction limitation rule

- ▶ As regards pre-existing/ historical liabilities (i.e. any debt instruments or liabilities with terms agreed upon before 9 December 2022), net interest expenditure in relation to the same are not subject to general interest deduction limitation rule.

- ▶ In relation to such historical liabilities, the Guide clarifies that the aforesaid exception also applies to all contracts entered to hedge the interest rate risk on such historical liabilities, irrespective of whether such hedge contract is entered into before or after 9 December 2022.
- ▶ The Guide also provides illustrations to explain the applicability of aforesaid exception in the context of historical liabilities, where the principal drawdowns of such debt/ loan are made after 9 December 2022 (in contexts where lender was legally required to provide the funds upon completion of specific deliverables or project phases, and otherwise).

Interplay of general interest deduction limitation rule with other provisions

- ▶ As regards interplay of general interest deduction limitation rule with other provisions of the UAE CT law, the Guide effectively clarifies that
 - initially, the general rules for deduction of interest expenditure (i.e. requirement of such expense being incurred wholly and exclusively for the purposes of the Business and not being capital in nature, etc.) should apply, followed by applicability of the provisions of Specific Interest Deduction Limitation Rule under Article 31 of UAE CT law;
 - any interest expenditure allowable as per the aforesaid provisions of the UAE CT Law should then be tested for conditions of general interest deduction limitation rule under Article 30 of UAE CT Law.
- ▶ In case where the taxable person incurs any interest expense not corresponding to the arm's length principle, the amount of expense adjusted to meet the arm's length principle should be considered for the purposes of general as well as specific interest deduction limitation rules.

Exception from applicability of general interest deduction limitation rule

- ▶ As per the UAE CT Law, the general interest deduction limitation rule is not applicable for banks, insurance providers, natural persons undertaking business/ business activity in the UAE, and any other persons to be determined by the Minister.

The Guide clarifies that such exception is not applicable for treasury companies, captive insurance companies, and other non-regulated financial institutions carrying out quasi-banking/ insurance activities, or investment vehicles whether regulated or not. Thus, such institutions will remain subject to the limitation rule under Article 30.

- ▶ Further, in case of natural persons conducting business activity through a juridical person (for instance, as an owner of a one-person company), the same should be considered as a juridical person and thus, be subject to the general interest deduction limitation rule.

- ▶ The Guide has also provided a detailed explanation with illustrations on the treatment of interest relating to Qualifying Infrastructure Projects (QIP) for the purposes of general interest deduction limitation rule along with detailed explanation on conditions for a project to be treated as QIP.

Interest expense pertaining to a QIP should be fully deductible while calculating the taxable income (regardless of the amount), subject to satisfaction of requisite conditions.

Relevant clarifications in the context of specific interest deduction limitation rule

- ▶ Specific interest deduction limitation rule is not applicable if the main purpose of obtaining the loan and carrying out one of the transactions listed under Article 31 of UAE CT Law is not to obtain a corporate tax advantage.

The Guide clarifies that the onus is on the taxable person to demonstrate that the main purpose is not to gain a corporate tax advantage, having regard to specific facts and circumstances.

- ▶ UAE CT Law presumes there being no corporate tax advantage if the Related Party earning the interest income is subject to corporate tax or a similar tax under the applicable legislation of a foreign jurisdiction at an effective rate (ETR) of not less than 9%.

The Guide clarifies that, the aforesaid ETR test may not be satisfied if the income is exempt or enjoys preferential tax treatment that results in tax of less than 9%.

MMJS INSIGHTS:

- ▶ The Guide offers a detailed and comprehensive overview of the provisions outlined under UAE CT Law in relation to interest expense/ income, with a specific thrust on Articles 30 and 31 of UAE CT Law, along with illustrations thereto for multiple scenarios.
- ▶ The Guide provides broad range of clarifications on the scope of the term “interest” to be considered for the purpose of net interest expenditure calculation.
- ▶ Additionally, the Guide also outlines the treatment of net interest expenditure computation for the purposes of Articles 30 and 31 under UAE CT Law in the case of non-resident juridical persons, such as permanent establishments, non-residents having nexus in the state, etc.
- ▶ Taxable persons may review any existing positions undertaken basis MD 126 issued previously and analyze the impact of additional clarifications outlined in the Guide for such positions.

You may refer to all Cabinet Decisions and Ministerial Decisions issued relating to the UAE CT regime on Ministry of Finance's website: www.mof.gov.ae or www.uaelegislation.gov.ae/en. Guides as well as Public Clarifications issued by the FTA under the UAE CT Regime are available on FTA's website: <https://tax.gov.ae/en/taxes/corporate.tax.aspx>

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