



# Tax Alert

---

27 January 2019

## THIN CAPITALISATION RULES CHANGED

### Executive Summary

Tax Ruling B68 issued on 27 December 2018 brings some major changes to the Thin Capitalization (Thin Cap) tax ruling B64, which was originally issued on 26 April 2018. The ruling also introduces a new rule in accounting for 'operating lease' transactions for tax purposes, in the books of the lessee, which deviates from the relevant accounting standard - IFRS 16 *Leases*.

### What are Thin Capitalization Rules?

Thin cap rules are the rules that impose limits on the amount of interest that can be deducted in calculating the profit for tax purposes. Generally, these rules are designed to counter cross border shifting of profit through excessive interest payments to associated enterprises. In the Maldivian context, the rules apply to domestic transactions as well.

### Overview of the previous rules on Thin Capitalization

**Issued on:** 26 April 2018

**Effective from:** 1 January 2018

#### What it does:

1. It imposes additional restrictions on the deduction of interest expenses in arriving at the taxable profit.
2. The rules are similar to the Fixed Ratio Rule proposed under Action 4 of the Base Erosion and Profit Shifting (BEPS) Project initiated by the OECD.
3. Applies to all taxpayers within charge to BPT in the Maldives, regardless of their size except:
  - ◇ insurance companies
  - ◇ housing finance companies
  - ◇ leasing finance companies

4. It puts a cap on the total interest expense deductible in a given year at 25% of the tax-EBITDA.
5. Tax-EBITDA is the taxable profit for the period, calculated before the deduction of loss relief, interest expense and capital allowances.
6. It applies to interest payable to:
  - ◇ MIRA approved banks and financial institutions;
  - ◇ non-approved parties.
7. It includes within its scope interest payments on all forms of debt, or payment economically equivalent to interest such as premiums for options, finance cost element of lease payments, etc.

8. It does not allow taxpayers to carry forward the excess interest or unused capacity to be deducted against the unused capacity of future years.

#### How does it apply in practice?

1. Thin Cap adjustment is made on the BPT Return:
  - ◇ 25% of the tax-EBITDA is calculated on the face of the return
  - ◇ If actual interest expense is higher than the CAP, the excess amount is disallowed in the BPT Return.
2. If there are no taxable profits, no amount can be deducted as interest expense.



*Over 115 countries and jurisdictions come together under the Inclusive Framework on BEPS to collaborate on the implementation of the OECD/ G20 BEPS Package. Maldives is also a member of the Inclusive framework.*

*Photo: Sifah Saeed*

## What Changed?

### 1. Increased the cap to 30%

The new ruling raises the interest Cap from 25% to 30% of the tax-EBITDA.

### 2. Thin cap rules don't apply to SMEs and SOEs

Under the old Ruling, insurance companies, housing finance companies and leasing finance companies were not subject to the thin cap rules. This list has now been expanded under the new Ruling, to include:

- ◇ persons whose turnover is MVR 20,000,000 (Twenty Million Rufiyaa) or less, and;
- ◇ State Owned Enterprises that the Government of Maldives holds a majority stock of the ordinary share capital.

### 3. Interest fully deductible for Maldivian financial service providers registered with the MMA

The Ruling now permits full deduction of the total amount of interest payable to any bank, housing finance company or lease finance company licensed by the Maldives Monetary Authority (MMA). Thin Cap rules would still apply to MIRA approved banks and financial institutions which are not licensed by the MMA, except for the type of debts mentioned in Paragraph 4 below.

### 4. Interest may be fully deductible if the debt is used to finance education or healthcare services

The ruling now permits a full deduction of the total amount of interest paid or payable to a bank or financial institution approved by the MIRA, provided that the debt is used to finance education services, or health services provided a respective service provider registered with the relevant government authority. However, this special rule for the deductibility of interest for debt financing of these

types of public benefit services will cease to apply after 5 (five) years elapses from the first day of the tax year in which operation of the public benefit service commences.

### 5. Classification of a lease as 'operating lease' by the lessee

#### 5.1 What the accounting standard says:

The International Accounting Standards Board issued IFRS 16 (new standard) which superseded the old leasing standard IAS 17 *Leases*, which became effective for annual periods beginning on or after 1 January 2019.

Under the new standard, lessees do not classify leases as finance or operating anymore (although lessors still have to). Instead, they are required to recognize on the balance sheet, lease liability for the obligation to make lease payments and right of use (ROU) asset for the right to use the underlying asset over the lease term, instead of booking all payments straight line on profit or loss. Subsequently, the lessee needs to depreciate the ROU asset in accordance with the depreciation requirements of IAS 16, and recognize interest on the lease liability.

For lessors, accounting for leases under the new standard is substantially the same as it was under IAS 17. This means the lessors will keep on classifying all leases using the same classification principles in IAS 17 and distinguish between the two types of leases; operating and finance leases.

#### 5.2 What the tax ruling says:

The amended ruling requires lessees to classify leases as either operating or finance leases for tax purpose (although for accounting purpose, IFRS 16 would still apply), effectively requiring taxpayers to apply a method like IAS 17's operating lease



accounting. As IFRS 16 generally requires a single model accounting for lessees (and therefore does not require classification of a lease as finance or operating) the Tax Ruling requires the said classification to be based on the classification test that applies to lessors under IFRS 16. An operating lease, determined as such should be deducted on straight line basis (hence no capital allowance or interest expense needs to be considered for tax purpose). This adjustment will be made in the BPT Return itself and is likely to have a significant impact on the following type of businesses.

1. Tourism-related businesses
2. Airline operators
3. Telecommunication industry
4. Real estate businesses

The tax treatment for 'finance lease' transactions remains the same as IFRS 16.

The below example illustrates how the lessees can account for 'operating lease' transactions under IAS 17, IFRS 16 and tax purposes.

Amazing Company Pvt Ltd rents an immovable property (a building) from XYZ Company for a period of 10 years, starting from 1 January 2017. Based on the economic life of the asset, lease term, etc., Amazing Company has classified this transaction as an operating lease in 2017 under the requirements of the IAS 17. Below table illustrates how the lessee will account for this contract under IAS 17, IFRS 16 and the New Thin Cap Rules:

	IAS 17 (old standard)	IFRS 16 (new standard)	Tax Treatment
<b>Classification</b>	Classify as operating or finance lease	No classification is necessary for the lessee (although lessor will have to classify the lease as operating or finance)	Classify based on classification rules for lessors under IFRS 16 (in this example, classify as an 'operating lease')
<b>Initial measurement</b>	N/A	Recognize right to use asset and lease liability (lease liability is the Present Value of lease payments over the lease terms)	N/A
<b>Subsequent recognition</b>	Book the rental expenses on straight line basis (or another basis that may be appropriate)	Recognize depreciation on the right to use asset  Recognize remeasurement of the lease liability to include interest and exclude amounts paid	Book the rental expenses on straight line basis (as the lease was classified as 'operating')

## Our comments

The amended Ruling, although has brought significant changes that were not addressed when MIRA initially issued the Ruling, will add a degree of complexity to the BPT Regime. The ruling has still not addressed to certain issues that are of concern, such as carrying forward of unutilised interest expenses. Although it is a major relief that the Thin Cap rules do not apply anymore to businesses with annual turnover of less than MVR 20 million, we observe that it will still have a significant impact on many other businesses. Further, the rationale behind the special levy that has been given to education and health care service providers is not very clear - especially from a policy perspective.

The MIRA has also brought major changes to the BPT Return, to cater for the Thin Capitalisation Rules.

For additional information with respect to this tax alert, please contact the following members of our team:



### **Madeeh Ahmed**

Senior Tax Advisor  
madeeh@ctlstrategies.com  
+960 7783337



### **Hamdhulla Hussain**

Senior Tax Advisor  
hamdhulla@ctlstrategies.com  
+960 7980073



### **Zaidan Jaleel**

Senior Associate  
zaidan@ctlstrategies.com  
+960 7909876

### **About us**

CTL Strategies LLP is a multi-disciplinary law firm that provides comprehensive legal solutions to both local businesses operating globally and foreign businesses with interests in the Maldives. Our team is comprised of corporate and tax lawyers, tax advisors and chartered accountants.

We are ranked by Asia Law Profiles as a highly recommended firm in the areas of litigation and disputes.

### **Contact us**

Third Floor, H. Meerubahuruge Aage

Ameer Ahmed Magu

Male', Maldives

+960 7956996

[ask@ctlstrategies.com](mailto:ask@ctlstrategies.com)

[www.ctlstrategies.com](http://www.ctlstrategies.com)

This publication is intended for informative purposes only, and is designed to give a general overview of the issues discussed. Any information presented or opinion expressed should not be taken as legal or tax advice. Readers are advised to seek professional advice prior to taking any action on issues dealt with in this publication.