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Guide to Limitations on Interest Deductions

MIRA M854

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Taxpayers can rely on this guide as to the MIRA's interpretation of the relevant tax laws and regulations. If you do not understand anything in this guide or have queries related to your particular circumstances, call 1415 or send an email to 1415@mira.gov.mv.

List of abbreviations

BEPS	Base Erosion and Profit Shifting
CG	Commissioner General of Taxation
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisation
ITA	Income Tax Act (Law Number 25/2019)
MIRA	Maldives Inland Revenue Authority
MMA	Maldives Monetary Authority
MSME	Micro, Small and Medium Enterprises
MNE	Multinational enterprise

Definitions

1. Debt

“Debt” refers to any loan, financial instrument, finance lease, financial derivative, or arrangement that gives rise to interest, coupons, discounts or any other finance charges deductible in the computation of a person’s taxable income.

2. Finance lease

“Finance lease” refers to any lease under which substantially all the risks and rewards incidental to ownership of an asset are transferred to the lessee.

3. Interest capacity

“Interest capacity” refers to 30% (thirty percent) of a person’s tax-EBITDA in any given accounting period.

4. Loan

“Loan” means an amount (whether or not in money) given at any time by a person (referred to as the “first person”) to another person (referred to as the “second person”) under the terms of which the second person has an obligation to pay an amount at a future time, and includes accounts payable and obligations arising under finance leases, promissory notes, bills of exchange and bonds.

5. Operating lease

“Operating lease” means any lease that is not within the definition of a finance lease.

I. Introduction

Businesses may require new investments and funding to keep up with the growth in trade and competition. One source of such investment and funding very often comes in the form of external borrowings or debt. Businesses may use cross-border / domestic third-party or related party borrowings to finance the need for new investments and cashflow difficulties to run day-to-day operations. Interest is the cost for the borrower, which would generally be a deductible expense where interest is incurred to derive taxable income, thereby reducing the amount of business income subject to tax. Hence, interest, or payments economically equivalent to interest to third-party or related party lenders erode the tax base, and perhaps is one of the simplest profit-shifting techniques used in tax planning, especially by MNEs. The use of related party debt financing to achieve excessive interest payments is a significant area of tax risk.

Although interest is generally a deductible expense in the computation of the taxable income, certain rules exist to limit the deductibility of interest in the Income Tax Act. The aim of these rules is to counter Base Erosion and Profit Shifting (BEPS) risks associated with interest expense and allow an interest deduction which fairly reflects the business income or operations of the business. There are two specific rules prescribed in the ITA to limit the deduction of interest. These include a cap on the interest rate on loan and a robust thin-capitalisation rule that meets the international best practice.

2. Scope of 'interest' for the purpose of income tax

“Interest” means any payment (excluding the principal amount), under a debt security or loan or swap or derivative arrangement or a transaction in respect which a payment that is economically equivalent to interest is payable, and any commitment, guarantee or service fee paid in respect of a loan or swap or derivative arrangement, including discounts, premiums, passive interest and profit received in respect of any Islamic financial instrument.

Three broad elements covered in the definition include (1) interest on all forms of debt, (2) payments equivalent to interest and (3) expenses in connection with raising of finance.

Below are some of the specific examples of payments which come under the meaning of interest:

- payments under profit participating loans.
- imputed interest on instruments such as convertible bonds and zero-coupon bonds.
- amounts under alternative financing arrangements, such as Islamic finance.
- the finance cost element of finance lease payments.
- capitalised interest included in the balance sheet value of a related asset, or the amortisations of capitalised interest.
- amounts measured by reference to a funding return under transfer pricing rules, where applicable.
- notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings.
- guarantee fees with respect to financing arrangements.
- arrangement fees and similar costs related to the borrowing of funds including commitment fees.

Items below are not included in the scope of interest:

- discounts on provisions not related to borrowings.
- Additional charge rental payments under operating lease.
- royalties.

- arrangement fee or guarantee fee in relation to letter of credit (LC) where the LC is not related to raising finance but a guarantee that the person has the required funds in the bank.
- Telegraphic Transfer (TT) charges.

3. The rules on limiting deduction of interest

3.1 6% cap

The ITA imposes a cap on the maximum amount of interest or finance cost that is deductible if the interest or finance cost is paid to a person other than a bank or financial institution approved by CG. The additional portion paid to such persons in excess of a rate of 6% per annum is not deductible. If the actual amount of interest or finance cost paid to such persons is at a rate of 6% per annum or below, that actual amount is deductible, assuming the amount of interest or finance cost deductible is not restricted by the thin capitalisation rule or any other rule.

3.1.1 Banks and non-banking financial institutions approved by the CG

Deducting interest or finance cost payable to banks approved by CG or non-banking financial institutions approved by CG will not be affected by the 6% cap.

The banks and non-banking financial institutions, approved by the CG for this purpose are:

- Banks that have been granted a banking license by the central bank of the country of operation of that bank.
- Non-banking financial institutions licensed by the central bank of the country of operation or the respective regulatory body to conduct housing finance businesses or leasing finance businesses.
- Non-banking financial institutions licensed by the Maldives Monetary Authority to conduct development finance business.
- Non-banking financial institutions licensed by the Maldives Monetary Authority to conduct insurance business.
- International financial institutions (IFIs) and agencies controlled by such institutions.

Interest or finance cost payable to IFIs would be exempt from the 6% cap for that particular year if the IF is approved on or before the due date of filing of the income return for the tax year. Below is the list of IFIs approved as of the publication of this guide.

#	Name of the Institution	Approved Date
1	World Bank	1 January 2020
2	International Monetary Fund (IMF)	1 January 2020
3	Asian Development Bank (ADB)	1 January 2020
4	Islamic Development Bank (IDB)	1 January 2020
5	European Investment Bank (EIB)	1 January 2020
6	European Bank for Reconstruction and Development (EBRD)	1 January 2020
7	Nordic Investment Bank (NIB)	1 January 2020
8	OPEC Fund for International Development (OFID)	1 January 2020
9	Deutsche Investitions- und Entwicklungsgesellschaft (DEG)	1 January 2020
10	Groupe Agence Française de Développement (AFD)	1 January 2020
11	Asian Infrastructure Investment Bank (AIIB)	1 January 2020

Find out more

More information on approved banks and non-banking financial institutions, and the most up-to-date list of IFIs are available at <https://shorturl.at/dkxIV>.

Example 1: Interest paid to non-approved persons

In the tax year 2X21, ABC Pvt. Ltd. paid MVR 200,000 as interest on a loan borrowed from JKL Pvt. Ltd. The interest rate was 10% per annum. JKL Pvt. Ltd. is neither an approved bank nor an approved financial institution. Assuming there are no further restrictions on the deduction of interest due to any other rule, what is the maximum amount of interest that ABC Pvt. Ltd can deduct in the computation of taxable income?

The 6% cap applies and therefore the maximum amount deductible as interest in this case would be MVR 120,000.

Example 2: Interest paid to approved banks and financial institutions

Interest expense of the STU Pvt. Ltd. for the tax year 2X21 was MVR 1.5 million, payable at rate of 8% per annum to the National Development Bank PLC (NDB Bank) of Sri Lanka. NDB Bank is a bank licensed by the Central Bank of Sri Lanka. Assuming there is no restriction on the deduction due to any other rule, what is the maximum amount of interest that STU Pvt. Ltd could deduct in the computation of taxable income?

Since NDB Bank is a bank operating in Sri Lanka under a license from the Central Bank of Sri Lanka, STU Pvt. Ltd. can deduct the full amount of MVR 1.5 million as interest in the year 2X21.

Example 3: Interest paid to approved banks and financial institutions

The interest expense of STU Pvt. Ltd. for the tax year 2X21 was MVR 3 million, payable at a rate of 15% per annum to WT Money Mover Pvt. Ltd., which is a money transfer agency licensed by the MMA. Assuming there is no restriction on deduction due to any other rule, is the full amount of interest payable to WT Money Mover Pvt. Ltd deductible?

Although WT Money Mover Pvt. Ltd. is a money transfer agency licensed by the MMA, it is neither a CG-approved non-banking financial institution nor a bank. Hence, the interest portion paid in excess of 6% per annum would not deductible.

3.2 The thin-capitalisation rule

Thin capitalisation refers to financing investment and operations through a far higher level of debt than equity. As discussed above, excessive deduction on interest reduces the tax paid in the country. Consequently, the Maldives has implemented a thin capitalisation rule in the ITA to prevent erosion of the income tax base with excessive interest deduction. This rule is based on best practice recommendations made in the final report of Action 4 (Limiting Base Erosion involving Interest Deductions and Other Financial Payments) of the BEPS Action Plan.

The thin capitalisation rule limits the total amount of interest a person can deduct in the computation of taxable income to a maximum of 30% of tax-EBITDA. 30% of the tax-EBITDA of the person for the accounting period is known as the interest capacity. The total interest expense that exceed the interest capacity for that period will be denied a deduction in that period. The disallowed interest in this manner for given period can be carried forward to be deducted within the interest capacity of subsequent periods up to a maximum of 10 years.

The brought forward amount of disallowed interest must be deducted first before deducting any current year interest that is subject to the thin capitalisation rule. The earlier disallowances brought forward must be claimed before a later one.

3.2.1 Persons exempt from thin capitalisation rule

Interest expense limitation from the thin capitalisation rule does not apply to the following persons. In other words, the interest expense deduction by these persons are unaffected by the thin capitalisation rule irrespective of to whom the interest is paid.

- Micro, Small or Medium sized businesses (MSMEs) under the Law on Small and Medium Enterprises.
- State-Owned Enterprises (SOEs), of which the Government of the Maldives directly holds majority of the ordinary share capital.
- Banks licensed under the Maldives Banking Act.
- Insurance businesses or finance leasing businesses or housing finance businesses or non-banking financial institutions licensed to conduct financing business under the Maldives Monetary Authority Act.

3.2.2 Interest expense exempt from thin capitalisation rule

In addition to the above, deduction available in respect of interests paid to the following persons are not affected by the thin capitalisation rule:

- Banks licensed under the Maldives Banking Act.
- Insurance businesses or finance leasing businesses or housing finance businesses licensed to conduct financing business under the MMA.

Find out more

Details of banks, insurance, finance leasing and housing finance business licensed by MMA can be viewed from the links below.

- Register of Banks <https://shorturl.at/krIOT>
- Register of insurance providers <https://shorturl.at/DIRYZ>
- Other Financial Institutions <https://shorturl.at/imA29>

In all other cases, the total interest deductions that are subject to the thin capitalisation rule should not exceed the interest capacity for a period.

3.2.3 Computation of tax-EBITDA

Tax-EBITDA for a period is calculated as a sum of the following figures:

- Taxable income/(loss) from business before deduction of zakat al-mal, donation and business loss relief.
- Interest paid/payable to approved banks and financial institutions.
- Interest paid/payable to persons other than approved banks and financial institution (i.e. interest subject to 6% interest rate cap rule discussed in [section 3.1](#). Here take into account only the portion within the 6% rule.
- Capital allowances claimed.
- Balancing allowances claimed.

If the computed tax-EDBITDA is zero or negative, then the interest capacity for the period would be zero. In such cases no interest expense subject to the thin capitalisation rule would be deductible.

Example 4: Thin capitalisation rule

Consider the following information of MNO Pvt. Ltd. for the tax year 2X21.

	<i>MVR</i>
<i>Taxable income/(loss) before loss relief</i>	<i>75,000</i>
<i>Interest paid to a bank operated in the Maldives</i>	<i>100,000</i>
<i>[no other interest expense incurred]</i>	

What would the amount of interest expense deductible in the year 2X21?

The thin capitalisation rule would have no impact on the amount of interest deductible, as the interest was paid to a bank operated in the Maldives (under MMA license). Hence, interest amount of MVR 100,000 would be fully deductible.

Example 5: Thin capitalisation rule

Consider the following information of PQR Pvt. Ltd. for the tax year 2X21.

	MVR
<i>Taxable Income before loss relief</i>	<i>1,000,000</i>
<i>Interest paid to banks operated in the Maldives</i>	<i>500,000</i>
<i>Interest paid to a leasing finance company in Singapore</i>	<i>3,000,000</i>
<i>Capital allowance claimed</i>	<i>200,000</i>

What would the amount of interest expense deductible in the year 2X21?

In this case interest paid to the bank operated in the Maldives would be fully deductible. However, interest paid to the leasing finance company operated in Singapore, irrespective

of the fact that the leasing company is a MIRA approved financial institution, would be subject to the thin capitalisation rule.

	MVR	MVR
[A] Taxable Income before loss relief		1,000,000
[B] Interest paid to banks operated in the Maldives	500,000	
[C] Interest paid to a leasing finance company in Singapore	3,000,000	
[D] Capital allowance claimed	<u>200,000</u>	
		<u>3,700,000</u>
[E] Tax-EBITDA (A+B+C+D)		4,700,000
[F] 30% of Tax-EBITDA (0.3 multiplied by E)		<u>1,410,000</u>
Max. deductible		
<ul style="list-style-type: none"> • [G] Interest paid to bank approved by MMA (Not subject thin cap restriction) • [H] Interest paid to leasing finance company in Singapore up to interest capacity since it is in excess of the capacity 		500,000 1,410,000
Amount of interest disallowed (C -H)		1,590,000

The amount of disallowed interest can be carried forward to subsequent periods.

Example 6: Thin capitalisation rule

Consider the following information of STU Pvt. Ltd. for the tax year 2X21.

	MVR
Taxable income/ (loss) before loss relief	(6,500,000)
Interest paid to persons not approved at 6% per annum	2,000,000
Capital allowance claimed	3,000,000

What would the amount of interest expense deductible in the year 2X21?

Interest paid to the persons not approved by MIRA would be subject to the thin capitalisation rule.

	MVR	MVR
<i>Taxable income/ (loss) before loss relief</i>		(6,500,000)
<i>Interest paid to persons not approved at 6% per annum</i>	2,000,000	
<i>Capital allowance claimed</i>	<u>3,000,000</u>	
		<u>5,000,000</u>
<i>Tax-EBITDA</i>		(1,500,000)
<i>interest capacity (negative EBIDTA equals interest capacity of zero)</i>		0
<i>Max. deductible</i>		0
<i>Amount of interest disallowed</i>		2,000,000

If the tax-EBITDA is negative, no interest is deductible under the thin capitalisation rule.

The amount of disallowed interest can be carried forward to subsequent periods.

Example 7: Thin capitalisation rule

Consider the following information of XYZ Pvt. Ltd. for the tax year 2X21.

	MVR
<i>Taxable income/ (loss) before loss relief</i>	(6,500,000)
<i>Interest paid to MIRA approved banks operated in the Maldives</i>	1,000,000
<i>Interest paid to persons not approved at 6% per annum</i>	2,000,000
<i>Capital allowance claimed</i>	2,500,000

What would the amount of interest expense deductible in the year 2X21?

Interest paid to the persons not approved by MIRA would be subject to the thin capitalisation rule.

	MVR	MVR
<i>[A] Taxable income/ (loss) before loss relief</i>		<i>(6,500,000)</i>
<i>[B] Interest paid to MIRA approved banks operated in the Maldives</i>	<i>1,000,000</i>	
<i>[C] Interest paid to persons not approved at 6% per annum</i>	<i>2,000,000</i>	
<i>[D] Capital allowance claimed</i>	<i>2,500,000</i>	
<i>[F] Balancing allowance claimed</i>	<u><i>500,000</i></u>	
		<u><i>6,000,000</i></u>
<i>[G] Tax-EBITDA (A+B+C+D+E)</i>		<i>(500,000)</i>
<i>[H] Interest capacity (0.3 multiplied by G) *</i>		<i>0</i>
<i>Max. deductible**</i>		<i>1,000,000</i>
<i>Amount of disallowed interest</i>		<i>2,000,000</i>

*[H] Negative tax-EBITDA means interest capacity is zero.

** Irrespective of an interest capacity of 0, interest paid to the approved banks operated in the Maldives would be deductible.

However, interest paid to persons not approved will not be allowed to be deducted as interest capacity is 0. MVR 2,000,000 can be carried forward as amount of interest disallowed.

3.3 Treatment of borrowing costs that are capitalised

For accounting purposes, taxpayers may capitalize borrowing costs in accordance with the approved accounting standards adopted by the taxpayer. However, for the purpose of claiming capital allowance, taxpayers should not include the amount of interest or finance cost as a part of the cost price of an asset. In other words, capitalized borrowing costs are also subject to the same interest deduction limitation rules mentioned above. When claiming capital allowance for a capital asset, the capitalised borrowing cost must be removed from the cost of the asset and deducted in accordance with the interest deduction rules. Consequently, interest or borrowing costs that are capitalized must also be included in calculating tax-EBITDA.

This rule does not apply to capital assets where the borrowing cost of such an asset was included in its cost price in a period prior to the tax year 2020.

For borrowings made before 2020 and where borrowing cost has been capitalized, such borrowing cost can be included in the cost of the asset and deducted as capital allowance. However, any borrowing cost not capitalized or borrowing cost incurred after 2020 must be deducted as interest expense subject to interest limitation rules in this guide.

Example 8: Borrowing cost incurred on borrowings made on or after 2020

In the tax year 2021, PQR Pvt. Ltd. commenced construction of a building which would be wholly financed through a shareholder loan of MVR 5,000,000, with an interest rate of 10% per annum. The property will be completed on 1 January 2024 and will be recognized as a part of the PPE in the SOFP for the year 2024. Assuming the full amount of borrowing cost would be required to be capitalized, MVR 6,500,000 will be taken as the cost of the building, on which depreciation will be calculated for the purpose of determining the carrying value of the PPE in the year 2024.

What would be the cost price of the building on which PQR can claim capital allowance?

The cost price of the building to be used when claiming capital allowance should be MVR 5,000,000 after removing borrowing cost capitalised.

Assuming the following

- interest rate is on arm's length terms
- the interest deduction was not affected by the thin capitalisation rule.
- the shareholder is neither a bank and nor a CG approved FI.

PQR Pvt. Ltd will be allowed a deduction for interest, not exceeding the amount computed at a rate 6% per annum, as the interest is incurred. This deduction is unaffected by the progress of the property or capitalisation of the borrowing cost.

Relevant laws and regulations

- Income Tax Act (Law Number 25/2019)
- Income Tax Regulation (Regulation Number 2020/R-21)
- Small and Medium Enterprises Act (Law Number 6/2013)
- Maldives Monetary Authority Act (Law Number 6/81)
- Maldives Banking Act (Law Number 24/2010)



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