Thin capitalisation requirements in Tanzania

Tanzania tax laws and practice

Introduction

Thin capitalisation refers to the ratio of debt to equity. Where a corporation is heavily **capitalised** by debt claims, it is considered to be thinly **capitalised**. In certain circumstances, a corporation that is thinly **capitalised** may not be entitled to a full deduction of its interest expense.

A company is typically financed (or capitalised) through a mixture of debt and equity. Thin capitalisation refers to the situation in which a company is financed through a relatively high level of debt compared to equity. Thinly capitalised companies are sometimes referred to as "highly leveraged" or "highly geared".

The way a company is capitalised will often have a significant impact on the amount of profit it reports for tax purposes. Country tax rules typically allow a deduction for interest paid or payable in arriving at the tax measure of profit. The higher the level of debt in a company, and thus amount of interest it pays, the lower will be its taxable profit. For this reason, debt is often a more tax efficient method of finance than equity.

Multinational groups are often able to structure their financing arrangements to maximise these benefits. Not only are they able to establish a tax-efficient mixture of debt and equity in borrowing countries, they are also able to influence the tax treatment of the lender which receives the interest – for example, the arrangements may be structured in a way that allows the interest to be received in a jurisdiction that either does not tax the interest income, or which subjects such interest to a low tax rate.

Why and how the revenue authority implements the Thin Capitalisation rule in Tanzania

The primary function of the revenue authority is to ensure that the Government gets its fair tax revenues from various businesses undertaken by the resident and non-resident persons within its jurisdiction.

Thin capitalisation rules were introduced to allow the government to restrict potential leakage in revenue in terms of taxation where investors could use the loophole to reduce corporate tax liability.

The avoidance would occur by way of high-interest expenses which reduces the taxable profits for corporations.

Generally, interest expense incurred by an entity on funds borrowed for use in generating business income is an allowable tax deduction under Section 11(2) and Section 12(1) of the Income Tax Act, 2004. However, Section 12(2) imposes restrictions on the deductibility of interest expense incurred by an exempt-controlled resident entity.

An entity is an exempt controlled resident entity if it is a resident and at any time during the year of income, 25% or more of the underlying ownership of the entity is held by entities exempt under the Second Schedule of the Income Tax Act, approved retirement funds, charitable organisations, non-resident persons or associates of such entities or persons. Exemption under the Second Schedule of the Income Tax Act applies to the amounts derived by the President of the United Republic of

Tanzania by virtue of the office as President, amounts derived by the Government except those derived from business activities that are unrelated to the functions of the Government; amounts derived by any person entitled to privileges under the Diplomatic and Consular Immunities and Privileges Act to the extent provided in that Act; amongst others.

The maximum interest that would qualify for tax deduction shall not exceed the debt-to-equity ratio of 7:3 i.e. For every 3 units of equity, the taxpayer can have a maximum of 7 units of debt. Hence, interest proportionate to the excess debt would be disallowed for corporate tax purposes. It should be noted that the excess interest will be permanently disallowed.

The term "debt" is defined under the Income Tax Act as any debt obligation, but **excludes** the following:

- A non-interest-bearing debt obligation;
- A debt obligation owed to a resident financial institution;
- A debt obligation owed to a non-resident bank or financial institution on which the tax on interest is withheld in the United Republic of Tanzania.

The term "equity" means;

- Paid up share capital;
- Paid up share premium; and
- Retained earnings on an unconsolidated basis determined in accordance with the generally accepted accounting principles.

Whilst the non-interest bearing debt obligation is not included in the computation of the debt to equity ratio, any loans received with no or reduced interest rate could be scrutinsed under the Transfer Pricing Regulations if such a loan is extended by related parties.

The challenges

The rationale behind the thin capitalisation rule is to secure government revenue by discouraging borrowings by resident entities from related non-resident entities which could result in high interest expenses and reduced corporation and dividend distribution taxes. Non-interest bearing loans from related parties are not to be excluded in the computation of debt to equity. This results in the entity having to procure debt from banks or financial institutions which levy higher interest rates to cover for the risks and profit margins. A "would have" approach could be a better solution to overcome this challenge. The "would have" approach considers whether there is a commercial need or justification, from the borrower's perspective, for all or part of a company's debt. The tax authority can thereafter assess whether there was a business or commercial need to procure the debt. If it is demonstrated that the additional debt was entered into purely to gain a tax advantage, then the interest payable on that debt would be disallowed.

The Act does not provide relief on the interest expense arising from loans which are not considered as debts from a tax perspective. In other words, whilst the law allows for exclusion of specific debts in the determination of debt to equity ratio, the determination of interest allowable does not exclude the interest paid on those debts which are excluded in the debt to equity formula.

This implies that when the exempt-controlled resident entity opts to borrow from resident financial institutions and is unable to maintain the required debt-to-equity ratio due to various reasons, the entity will not be able to fully claim the interest expense incurred on the loans from resident financial institutions.

Way forward

Exempt-controlled resident entities could plan on how to finance their business operations by maintaining the maximum debt-to-equity ratio of 7:3 to be able to claim all the interest expense incurred on borrowings. Alternatively, the entities must consider restructuring the balance sheet to ensure they have sufficient equity to meet the debt to equity ratios.

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