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Tax Evasion Using the Sale of Virtual Asset Losses with Application to Corporate and Business Tax in the United Arab Emirates

Prof. Tarek Abdel Salam[1*]

Abstract

This paper examines the challenges of applying UAE Corporate Tax Law to virtual assets, comparing it with Egyptian tax legislation. In the UAE, losses can be deducted from profits across different periods, with specific rules for carrying losses forward but not backward. Taxpayers listed on recognized stock exchanges are exempt from certain loss carryforward restrictions. Egyptian law, on the other hand, allows loss deductions and carryforwards for up to five years without limitations on the deduction percentage, but losses cannot be offset across different income sources. Applying UAE tax provisions to virtual assets is complex. The need for both parties to be resident entities complicates determining the residency of virtual assets. Additionally, calculating taxable income for virtual assets is difficult, especially with a 75% deduction limit on taxable income. The exemption for listed taxpayers further complicates the situation. To address these issues, it's recommended to exclude virtual asset losses from deductions and carryforwards due to difficulties in determining their value and verifying conditions. Also, the exemption for listed taxpayers should be removed. A more specific approach to taxing virtual assets is needed for a fair and consistent tax system.

Keywords: Tax Law, virtual assets, loss carryforward, tax exemptions, UAE and Egyptian laws.

Introduction

Tax evasion is considered one of the most significant economic crimes faced by various countries. The problem is exacerbated by virtual assets, which pose a major challenge to all tax systems, including the United Arab Emirates. The expansion of dealings in virtual assets may lead to a gradual decline in the tax base of traditional activities and sectors unless governments and tax authorities take steps to adapt their tax systems to account for these virtual assets (Da'bas, 2022). The traditional tax base is eroding, while the new base of virtual crypto assets faces technical difficulties (Elias, 2018).

One of the most significant challenges and risks facing tax systems is related to the deduction of losses. Most tax systems allow for the offsetting of losses against future income in some manner (Michaels AND & Ackerman, 2022). There are various safeguards in tax legislation to regulate the deduction of losses from one source of income against the profits from another source to prevent the misuse of these rules as a means of tax evasion. This type of challenge, the study of these rules, and their adequacy in achieving their intended purpose in the context of virtual assets will be the focus of this research (Joulah, 2021, Faqir, 2023).

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[1] Professor of Public Finance, Faculty of Law, Helwan University, E-mail: claw.dean@aue.ae
*Dean of the College of Law, American University in the Emirates, claw.dean@aue.ae (corresponding author). ORCID record is https://orcid.org/0009-0002-9855-3625

The research explores how tax systems might struggle due to significant losses in virtual asset transactions. Many tax systems allow loss deductions, which could be misused to offset losses from virtual transactions against other profitable income sources, potentially harming the tax base. This situation can be seen as "cross-subsidizing" crypto losses with non-crypto income.

Crypto losses pose a greater risk to tax revenue than losses in traditional markets for several reasons. First, extreme volatility in crypto assets leads to higher market fluctuations, partly due to a lack of investor protection and inefficiency in these relatively new markets. Second, the ease of access to virtual asset markets, with low entry barriers and quick access to trading platforms, exacerbates the problem.

To address this, regulations should be established to limit the deduction of virtual asset losses from overall project profits, at least until the crypto markets become more stable.

This research is important because it addresses a new issue in tax legislation, specifically focusing on the tax problems related to deducting virtual asset losses from corporate profits under UAE law. The study covers loss deduction, carryforward, tax safeguards against evasion, and the adequacy of UAE legislation in managing these challenges.

Literature Review

Some systems may prevent the deduction of losses from certain sources by offsetting income from other sources, requiring source matching. This means that they allow the deduction of losses from one source of income against gains from the same source (Ooi, 2023). However, others do not require this and allow the deduction of losses from one source of income against gains from another source. The tax system may face different levels of challenges depending on the business losses versus other sources of income. In the context of virtual assets, it is necessary to determine whether the activity of these assets is considered a genuine business activity or merely a form of gambling (Hasib, 2001).

The United Arab Emirates has entered a new phase by enacting several tax legislations, including Value Added Tax, Excise Tax, Corporate and Business Tax, and the Tax Procedures Law. Our topic is primarily connected to Corporate and Business Tax, which includes provisions related to the deduction and carryforward of losses (Bachle, 2021). The UAE Cabinet issued Decision No. (111) of 2022 regarding Virtual Assets and their Service Providers, and Dubai issued Law No. (4) of 2022 regarding the Regulation of Virtual Assets in the Emirate of Dubai. This has settled much of the debate (which still exists in many countries) about the legality of dealing with virtual assets (Crypto assets) in the UAE. However, it has opened a wide field of research on the challenges related to this legitimate application, and among the most significant challenges are those related to tax matters (Al-Mir, 2020, Ali and Faqir, 2024).

Loss deduction occurs due to the concept of financial unity, where related companies are treated as a single tax entity, allowing the deduction of losses from one company against the profits of another (Al-Saadani, 2017). This leads to the possibility of deducting losses from one source of income against the profits from other sources or deducting losses in the current year from the profits of future years (Burns and Krever, 1998). Therefore, it requires establishing rules and regulations for loss deduction (Al-Saadani, 2010).

Income tax is typically paid on the income earned during a year. This means that income losses must be assessed in the period they are earned or received and cannot be "transferred" from one year to another (Burns and Krever, 1998). However, many systems allow for the "carryforward" or "carryback" of losses to previous years if certain conditions are met. Allowing the carryforward or carryback of losses can negatively impact future revenue collection, as they can be used to offset future income, including income from other sources (unrelated to virtual assets) (Conlon, T., et al., 2022). Companies that incur significant losses in virtual assets (which are carried forward) may use these losses to offset income from profitable traditional businesses. Therefore, administrations and legislation must be cautious of companies using substantial virtual asset losses (that are carried forward) in traditional profitable businesses to offset income from these businesses (Bouakaz, 2013).

These risks arise from the concept of financial unity for related entities, where related companies can be treated as a single entity. This is achieved through group relief for related projects, allowing the transfer of losses from one company to another within the group for tax benefits (Rifaat, 1973). However, a company may join the group after incurring losses with the aim of allowing group members to benefit from these losses (Burns and Krever, 1998, Alrousan and Faqir, 2023). This increases the likelihood of what is known as "loss sales," where a company can be purchased to benefit from its losses (Muqbil, 2012).

Since this is a well-known method of tax evasion, many tax systems have established safeguards to prevent it. Without such measures, companies that have suffered substantial losses in cryptocurrency could be acquired solely to take advantage of those losses (Sher', 1996).

Methodology

This research employs a contemporary scientific methodology, combining both deductive and inductive approaches, to conduct two types of studies. The first is a comparative theoretical study, which uses content analysis of tax authorities' publications from various foreign countries regarding the tax treatment of virtual assets. The research examines the potential use of selling virtual asset losses as a tool for tax evasion and the role of tax legislation in addressing this issue, focusing on the United Arab Emirates in comparison with some developing and developed countries. The study considers the legislative provisions that allow for the carryforward of losses under certain conditions, such as time limits, linkage, and permitted percentages, both for single and multiple projects, and analyzes the impact of these provisions on tax evasion.

Discussion and Analysis

Addressing Tax Evasion Through Loss Sales

To combat tax evasion related to loss sales, some jurisdictions employ a "contribution test" as a protective measure. This test ensures that shareholders in a company are similar when it comes to deducting or carrying forward losses. There are typically limits on how many years losses can be carried forward or backward and the number of losses that can be transferred (Bournissa and Heemran, 2021). Companies that wish to transfer losses must ensure that a certain percentage of shares is held by the same shareholders to qualify for the transfer. The purpose of this test is to maintain a connection between the companies involved in the loss transfer and to establish specific legislative provisions that address cryptocurrency losses (Al-Khatib, 2015, Faqir, 2013). This is important for managing the frequent challenges and controls associated with these types of losses (Sher', 1997).

Under UAE law, there is a clear distinction between the rules for deducting losses and those for carrying them forward (Al-Faqih, 2013). The legislation specifies conditions for each scenario. For deducting losses from the taxable income itself, Article 37 stipulates that the deduction cannot exceed 75% of the taxable income for the period in which the deduction is applied, before any tax relief is considered (Elias, 2018). Losses incurred before the introduction of corporate tax, losses before becoming subject to this decree-law, or losses from exempt assets are not eligible for relief (Michaels AND & Ackerman, 2022.

When it comes to deducting losses from another taxpayer's income, Articles 38 and 39 provide guidelines for this process. Article 38 addresses the deduction of losses from the taxable income of another taxpayer for the same period, specifying that both taxpayers must be legal entities and residents, and that one must hold at least 75% of the shares of the other, or a third party must hold 75% of both. This joint ownership must be in place from the start of the tax period in which the loss occurred until the end of the period in which the loss is deducted (Conlon, T., et al., 2022). Additionally, neither taxpayer should be exempt, should not be qualified in a free zone, and both must align on financial year-end dates and accounting standards (Joulah, 2021).

For carrying forward losses to another taxpayer in a future period, Article 39 requires that the same person or persons must hold at least 50% of the shares continuously from the beginning of the tax period in which the losses occurred until the end of the period when the losses are deducted. The taxpayer must also continue to engage in the same or similar business activity after a change in ownership exceeding 50%. The article further outlines factors to consider determining whether the taxpayer is continuing with the same business or a similar activity, including the use of the same assets, the absence of significant changes to the business identity or core operations, and the nature of any changes resulting from asset development or service exploitation (Hasib, 2001). Notably, these conditions do not apply to taxpayers whose shares are listed on an approved stock exchange (Bournissa and Heemran, 2021).

Carrying Forward Losses Under Egyptian Law

Article 29 of the Egyptian Income Tax Law states: "If the account for a given year ends with a loss, this loss may be deducted from the profits of the following year. If the profit is insufficient to cover the entire loss, the remaining portion shall be carried forward to next year (Al-Saadani, 2017). If there is still a part of the loss left, it may be carried forward to the following years, up to a maximum of five years. However, losses cannot be carried forward beyond this period (Bachle, 2021).

This provision allows businesses that end their tax year with a net loss to offset this loss against profits made in subsequent years, with a maximum carry-forward period of five years (Al-Saadani, 2010). This is known as the loss carry-forward principle and serves as an exception to the principle of annual tax periods (Al-Faqih, 2013). It is designed to assist businesses that have incurred a loss each year by allowing them to recover this loss through profits in future years before paying tax on those profits (Muqbil, 2012, Faqir and Alrousan, 2023). Since the state benefits from the success of businesses by receiving financial resources related to that success, it is natural for the legislation to permit taxpayers to offset losses by carrying them forward to years in which they make a profit (Ooi, 2023). This ensures that businesses can recover an amount of profit equal to the loss they incurred, thus preserving their capital and encouraging their continued operation. Even though a business's fiscal life is divided into years or financial periods, these periods are interconnected in a continuous chain where the results of one affect the others (Al-Khatib, 2015). Therefore, it is necessary for all periods to collectively contribute to offsetting losses across the years.

Legislative Framework of Virtual Assets in the United Arab Emirates

On a legislative level, Dubai has issued Law No. 4 of 2022 concerning the regulation of virtual assets in the Emirate of Dubai. Additionally, the Council of Ministers issued Decision No. 111 of 2022 regarding the regulation of virtual assets and service providers. Below are key aspects of the legislation in each.

Definition of Virtual Assets in the UAE

Law No. 4 of 2022 defines virtual assets as a digital representation of value that can be traded digitally, transferred, or used as a tool for exchange, payment, or investment purposes. This includes virtual tokens and any other digital representation of value specified by the authority. Decision No. 111 of 2022 defines virtual assets as a digital representation of value that can be traded or transferred digitally and used for investment purposes. It does not include the digital representation of fiat currencies, securities, or other forms of money.

Although the definitions are similar, there is a significant difference between them regarding the nature of virtual assets. Dubai's Law includes digital representation of value for ownership and investment, as well as payment and exchange tools. In contrast, the Council of Ministers' Decision limits virtual assets to those used for investment and excludes digital representation of fiat currencies, securities, or other forms of money. This means that payment tools fall under the definition of virtual assets according to Dubai's Law but not under the Council of

Ministers' Decision (Al-Mir, 2020). The Decision specifies that virtual assets used for payment purposes are excluded and fall under the jurisdiction of the Central Bank, as outlined in Article 4(5) of the Decision. This has significant implications for tax treatment. Given that tax is federal, the definition in the Council of Ministers' Decision, being federal in nature, should be adopted. However, this discrepancy may lead to future tax disputes regarding the classification of such assets and whether they will be treated as currency or property, like issues experienced in the United States (Bouakaz, 2013).

Federal Decree-Law No. 47 of 2022 on Corporate Tax

Transactions involving virtual assets are subject to taxation under Article 2 of the law, which mandates that corporate tax be applied to taxable income according to the rates specified by this Decree-Law. The tax is payable to the authority as stipulated by this Decree-Law and the Tax Procedures Law.

Additionally, Article 11 of the law also applies to virtual asset companies. This article outlines that corporate tax is imposed on taxpayers according to the rates established by the Decree-Law. For the purposes of this Decree-Law, a taxpayer can be either a resident or a non-resident.

A resident is defined as:

- A legal entity established, created, or recognized under the laws of the country, including entities based in free zones.
- A legal entity established, created, or recognized under the laws of another country or foreign jurisdiction but managed and controlled effectively within the country.
- An individual engaged in business or business activities within the country.
- Any other person as may be specified by a decision from the Council of Ministers based on the Minister's proposal.

Tax on income derived from virtual assets is governed by Article 13 of the law. This article stipulates that income is generated within the country in the following circumstances:

- When earned by a resident individual or entity.
- When earned by a non-resident, provided the income was paid or due to a permanent establishment of that non-resident in the country and allocated to it.
- When earned or due from activities carried out within the country, assets located within it, invested capital, used rights, or services provided or utilized within the country.

Additionally, subject to any conditions and restrictions that may be set by the Minister, income generated in the country includes, but is not limited to (Al-Faqih, 2013):

- Income from the sale of goods within the country.
- Income from services provided, used, or benefitted from within the country.
- Income from contracts executed or utilized wholly or partially within the country.
- Income from movable or immovable property within the country.

- Income from transactions involving shares or capital owned by a resident.
- Income from the use or right to use intellectual or intangible property rights within the country, or permission to use such rights within the country.

Results

- The UAE Corporate Tax Law allows the deduction of losses from one income source against profits from another, applicable to the same period or subsequent periods. It also permits the deduction of losses from other taxable income within the same period and authorizes the carryforward of losses to subsequent periods, each subject to specific conditions. However, the carryback of losses to prior periods is not allowed. Additionally, taxpayers listed on a recognized stock exchange are exempt from certain conditions related to the carryforward of losses to another taxpayer in subsequent periods, as specified in Article 39, Paragraph 1.
- Egyptian law, on the other hand, permits the deduction and carryforward of losses for up to five subsequent years without setting a maximum deduction percentage and does not allow the deduction of losses from one taxable income against another.
- Applying these rules to virtual assets under UAE law presents several challenges. The requirement that both parties be resident legal entities complicates the determination of the residency status of virtual assets. Additionally, determining the taxable income of virtual assets is difficult when the deduction limit is set at 75% of the taxable income for the year in which the deduction is made.
- The treatment of taxpayers not listed on a recognized stock exchange is also challenging, particularly given the exemption for those who are listed. These issues highlight the complexities involved in integrating virtual assets into the existing tax framework.

Conclusion

The legislation allows for the deduction of losses from one income source against profits from another, applicable to both the same and subsequent periods, and permits carryforward of losses to future periods, subject to specific conditions, but does not allow carryback to prior periods. Taxpayers listed on a recognized stock exchange are exempt from certain conditions for carrying forward losses. In contrast, Egyptian law permits loss deduction and carryforward for up to five years without a maximum deduction percentage and prohibits deduction of losses from one taxable income against another. Applying these rules to virtual assets under UAE law poses challenges, including determining residency status and taxable income of virtual assets, and the treatment of taxpayers not listed on a recognized stock exchange.

Finally, the study concludes with following recommendations:

1. To address these challenges concerning the deduction and carryforward of losses for virtual assets, the following recommendations are proposed:

2. Exclude virtual asset losses from the deduction and carryforward provisions due to the difficulties in accurately determining their amount and verifying the applicable conditions.
3. Repeal the exemption stated in Paragraph 4 of Article 39 concerning taxpayers whose shares are listed on a recognized stock exchange.
4. Exclude virtual asset losses from being deducted or carried forward due to the difficulty in determining their actual amount and ensuring the conditions for application.
5. Repeal the exemption in paragraph 4 of Article 39 of the UAE Corporate Tax Law, which applies to taxpayers whose shares are listed on a recognized stock exchange.
6. Enhance technical measures to accurately determine profits and losses in the field of virtual assets.
7. Establish a specialized department to combat tax evasion in virtual assets and activate international cooperation agreements to facilitate communication regarding virtual asset transactions across countries.

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