International Tax Alert

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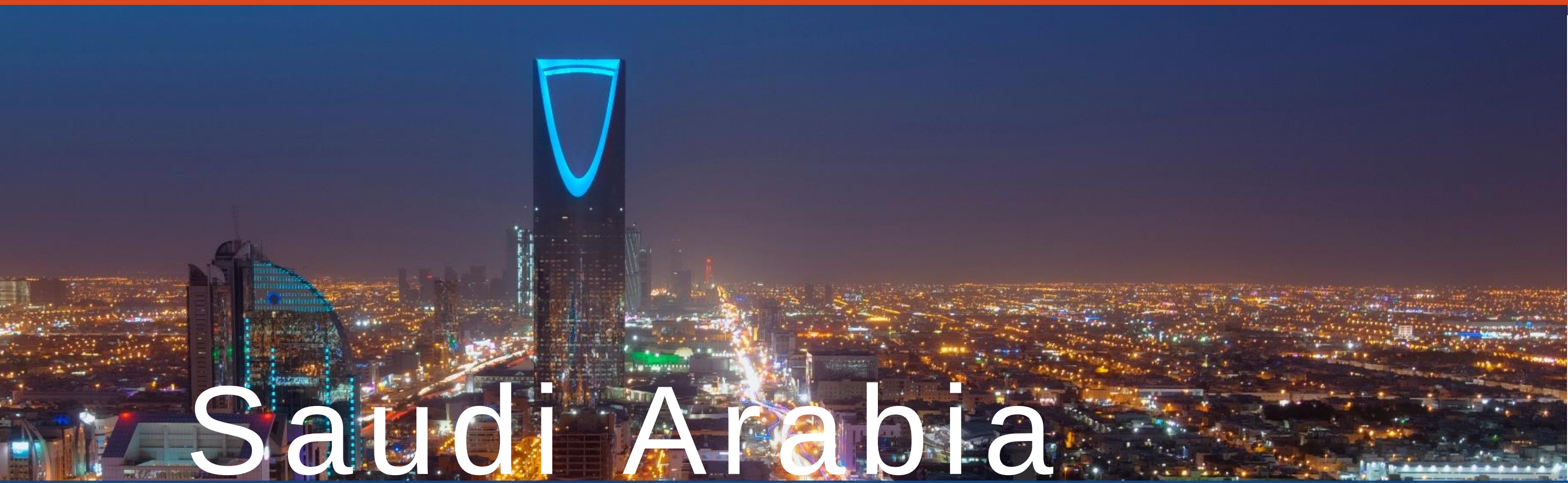

Saudi Arabia

Saudi Arabia has published Arabic text of the double tax treaty with UAE

Introduction

The Kingdom of Saudi Arabia (KSA) and the United Arab Emirates (UAE) had signed a landmark Double Tax Treaty (DTT) on 23 May 2018, being the first such agreement between two GCC members. Our previous alert on this matter can be accessed here.

The text of the KSA-UAE DTT has been published in the official KSA gazette, *Umm Al-Qura,* publicly made available on 5 March 2019. The DTT is currently available in Arabic only and can be accessed here. In view of publication by KSA in its official gazette, the ratification process stands complete by KSA. However, the UAE is yet to notify completion of the procedures to enforce the DTT. This DTT shall come into force on the first day of the second month after the notification procedures are completed by both countries. For DTT to apply from 1 January 2020, the UAE will need to complete its ratification procedure no later than 31 October 2019.

This alert discusses some of the key provisions of the DTT and also includes our analysis thereof.

Key highlights of the DTT

- Blend of Organisation for Economic Co-operation and Development (OECD) and UN Model Tax Conventions, and also includes some of the Multilateral Instrument (MLI) clauses.

- Tax residency based on the *liable to tax* criteria including legal persons established in the relevant country, and sovereign funds, and other entities that are generally exempt from tax primarily.

- 0% withholding tax on interest (5% under KSA Income tax law), 10% for royalties (15% under KSA Income tax law) and 5% for dividends (same as KSA Income tax law).

- 183 days Service Permanent Establishment (PE) clause, providing more certainty on the PE threshold for UAE Companies when their employees visit KSA for business purposes.

- Certain MLI recommendations on PE clauses included.

- Certain exemptions for income derived by Sovereign entities (i.e. Central bank, Public financial institutions and their wholly owned entities).

- Force of attraction rule for attribution of business profits to a PE.

- Principal Purpose Test (PPT) clause to access DTT benefits in line with OECD's Base Erosion and Profit Shifting (BEPS) Action Plan 6 and the MLI.

DTT provisions in detail

The DTT clauses are a blend of the OECD as well as UN Model Tax Conventions and also include some recommendations under the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

Some of the key features of the DTT are:

- **Residence** – As per the DTT, residents shall include any person who is liable to be taxed by virtue of his domicile, residence, place of incorporation or place of management or any other criterion of a similar nature. It also includes administrative divisions or local governments, sovereign funds owned by the Government or other entities that are generally exempt from taxation (like not for profit organisations).

  It would be pertinent to note that the DTT benefits are not restricted only to entities owned or controlled by the UAE/KSA/other GCC nationals. This provision appears in the recent Brazil-UAE treaty, wherein a UAE company must be directly or indirectly owned by the UAE/government institution of the UAE/political subdivision or local government thereof, or owned and controlled by UAE nationals domiciled in the UAE to qualify as *Residents* for the purpose of this treaty and accordingly receive treaty benefits.

  Also, there is no express restriction in the DTT for companies set up in the free zones that enjoy specific tax exemption issued by the free zone authorities to be able to claim the DTT benefits.

- **Treaty abuse** – In line with the MLI recommendations, Article 29 of the DTT provides for application of the PPT to deny grant of treaty benefits in cases where it is established that obtaining such benefit was one of the principal purposes of any transaction or any arrangement.

- **Dual resident entities** – A person (other than an individual) who is deemed to be a resident of both countries shall be treated as a resident of the country based on its place of effective management. In such cases, the DTT does not provide for determination of the residence by an agreement between competent authorities, as provided in the MLI.

- **Withholding taxes** – The treaty provides withholding tax rates for payments in the nature of dividends, interest and royalties. The following table captures the withholding tax rates:

Nature of payment	Withholding tax rate as per the Treaty	Domestic withholding tax rate in KSA	Domestic withholding tax rate in the UAE
Dividend	5%	5%	0%[1]
Interest[2]	0% (recipient should be the beneficial owner of such arm's length interest)	5%	0%[1]
Royalties	10% (recipient should be the beneficial owner of such arm's length royalty)	15%	0%[1]
Management fees	NA[3]	20%	0%[1]
Fees for technical service	NA[3]	5%/ 15%	0%[1]

From a procedural perspective, the following two options are available to UAE residents for claiming DTT benefits on withholding tax rates:

- Refund approach – Under this approach, KSA entity whilst making a taxable payment to the UAE residents should first deduct and pay withholding tax thereon and then apply for a refund. The refund application should be accompanied along with prescribed documents including Tax Residency Certificate (of the UAE residents).
- Benefit at source approach – Under this approach, it has been allowed by the General Authority of Zakat & Tax that the KSA entity may claim exemption or withhold tax based on the beneficial rates specified in the DTT, by submitting certain prescribed forms viz. Forms Q7/A (Statement of taxes withheld), Q7/B (Tax residency information) and Q7/C (Undertaking).

Where the KSA entity is unable to comply with the benefit at source approach, it should continue to follow the refund approach.

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[1] *Currently, there is no withholding tax regime in UAE*

[2] *Has been defined as income from debt claims of any kind, whether secured or not, including income from government bonds or debt securities including premium on such bonds or debt securities. However, it does not include penal interest.*

[3] *The DTT does not contain specific articles on Management fees and Fees for technical services. Accordingly, UAE residents providing such services or deriving income thereon from KSA, could argue that if in the provision of services there is no PE created in KSA then under the business profits article, there should be no tax (withholding tax) on such fees.*

- **PE clause** – PE Article includes:
  a. Construction PE clause (more than six months);
  b. Service PE clause (through employees or other personnel for more than 183 days within a 12-month period); and
  c. Agency PE clause which includes cases where a PE is created if a dependent agent maintains stock of goods from which it regularly delivers goods on behalf of the enterprise.

  For determining the existence of a PE, the DTT also includes provisions in relation to the following recommendations under the MLI:

  ➢ Deeming the existence of Agency PE in cases where the agent plays a principal role, leading to the conclusion of contracts without substantial modification (in addition to the provision where a dependent Agency PE is created by habitually exercising authority to conclude contracts, as present in the other treaties of KSA signed during 2018).

  ➢ Anti-fragmentation related provision i.e. non-availability of specific activity exemptions for the constitution of a PE where an enterprise (or its associate) carries out activities in the same or multiple places of business in the other country, and such additional activity/place constitutes a PE and the overall activities conducted are not of a preparatory/ auxiliary nature, provided the activities carried out by multiple projects are complementary functions and part of interrelated work.

  KSA Income tax law does not provide for a minimum period of activity to be performed inside KSA that would create a PE. As a result, a business activity by a UAE company for a single day in KSA, theoretically, could give rise to a PE under the KSA Income tax law. KSA has also been seeking to apply the *Virtual PE*[4] concept to provision of services by foreign companies. However, after the DTT enters into force, UAE residents can utilise the minimum threshold benefit prescribed under the DTT of 183 days physical presence in KSA, which should help cross border business activity / travel thereby minimising potential Virtual PE risk in KSA.

- **Business Profits** – The DTT provides for a limited force of attraction rule, whereby income from the sale of goods or carrying out other business activities, which are same or similar to the goods sold or activities carried out through the PE, will be included in the PE's assessable income which is taxable in the source state. This is similar to the limited force of attraction rule provided under Article 5(a)(10) of the KSA Income Tax Law.

[4] *As per the related internal guidelines of the GAZT, a non-resident shall be considered to have a Virtual PE in all cases where the non-resident provides services to KSA resident entities and the duration of service / contract exceeds 183 days within any 12-month period, regardless of the place where the service is rendered.*

- **Capital gains** – The DTT provides that capital gains derived by a UAE company from the sale of (a) immovable property located in KSA and (b) unlisted KSA company's shares, may be taxable in KSA. Listed company shares are exempt from source taxation under the DTT. Moreover, under the KSA Income tax law listed company shares are also exempt from tax (subject to prescribed conditions).

- **Entry into force** – As per Article 30, the DTT shall enter into force on the first day of the second month after the notification procedures are completed by both countries. In respect of withholding and other taxes, the DTT benefits will be available from 1 January following the date of entry into force. Thus, in order for the said DTT provisions to be applicable from the year beginning 1 January 2020, the notification procedures would need to be completed by 31 October 2019.

- **Others**

  Other key features of the DTT include:

  - Principle for elimination of double taxation via the foreign tax credit method;

  - Mutual agreement procedure provisions allowing taxpayers to raise objection with the competent authority of either contracting state.

  - Government investments and income from such investments shall be exempt from taxation in the other country, except for income from immovable property.

Key takeaways

The DTT should boost cross border transactions and trade flows as it provides certainty to taxpayers and the tax treatment in KSA. The DTT will also make the UAE more attractive as Holding / Financing company for investments in KSA given certainty on PE treatment and reduction in withholding tax rates. Besides beneficial ownership and arm's length criteria, the PPT from a treaty abuse perspective will need to be satisfied (i.e. economic and commercial substance).

From a practical standpoint, accessing the DTT withholding tax rates will require prescribed documentation under either the refund approach or benefit at source approach.

Against this backdrop, businesses should review their cross-border transactions and corporate structures to assess whether they are eligible for treaty benefits.

While both KSA and the UAE have signed the MLI, the UAE has not included KSA in its covered tax agreement list yet, and accordingly, unless the final ratified MLI position instrument is updated to effect the change, the treaty will not be modified by the MLI positions adopted by the UAE and KSA. Having said that, the UAE has expressed reservations on most of the MLI positions and including KSA may not change the current DTT provisions, unless the UAE changes its MLI positions at the time of ratifying the instrument.

For further information/ clarification on the applicability of the DTT or to discuss your structure and operations in KSA and/ or the UAE, please feel free to get in touch with the following:

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