

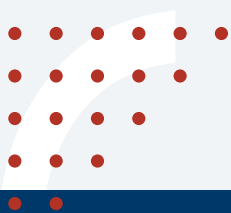
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A Ryan LLC Affiliate

TRANSFER OF A GOING CONCERN (TOGC) IN SAUDI ARABIA

KSA Taxation

TOGC



Transfer of a Going Concern (TOGC) is a common method for divesting, carving out underperforming or mature business ventures, or restructuring. It involves the transfer of a business, or an independent part of it, as a functioning and revenue-generating enterprise, rather than a piecemeal sale of individual assets.

In recent years, the regulatory framework in Saudi Arabia has evolved significantly. The Zakat, Tax and Customs Authority (ZATCA) has introduced key amendments to the Value Added Tax (VAT) and Real Estate Transaction Tax (RETT) legislations, bringing greater clarity to the tax treatment of TOGC transactions.

This article examines the VAT and RETT framework governing TOGC in the Kingdom and discusses the commercial considerations around mitigating exposure to transferred liabilities.

Regulations Governing TOGC Transactions

When executing a TOGC transaction in Saudi Arabia, businesses must navigate their tax obligations carefully. Under VAT, such transactions are not in-scope if they meet the specified conditions and may potentially still be taxable under RETT. Let's delve into the details.

Value Added Tax (VAT)

Under Saudi VAT Law and the VAT Implementing Regulations (IR), a qualifying TOGC is treated as outside the scope of VAT, i.e., no VAT is charged, on satisfaction of specified conditions laid down in Article 17 of the IR. In case the conditions are not met, the transaction is considered as a taxable supply subject to VAT at the standard rate of 15%. The conditions are as follows:



Regulations Governing TOGC Transactions (cont.)

1. The transferred business or economic activity must be capable of operating as an independent business, and the buyer/recipient must intend to immediately continue that same activity.

This implies that economic activity must be capable of being conducted as a going concern. Further, VAT Law or the IR do not provide for a fixed minimum lock-in period for the buyer to continue the said business. However, the buyer must intend to continue the same economic activity immediately after the transfer. If the buyer discontinues the business shortly after, ZATCA may challenge TOGC treatment and reclassify the transfer as a taxable supply.

2. The recipient must already be a VAT-registered taxable person or become one as a direct result of the transfer. Here, it is important to note that transfer of economic activity does not result in transfer of the supplier's tax identification number (TIN).

If the supplier ceases carrying on any other activity as a result of TOGC, it should apply for VAT de-registration.

3. Both parties must formally agree in writing to treat the transaction as a business transfer to reflect their intention of considering the transaction as TOGC.
4. Both parties must notify ZATCA of the TOGC within a specific time limit.

It is important to note that all the conditions need to be satisfied cumulatively. Failure to comply with any of the conditions could render the transfer subject to VAT.



Regulations Governing TOGC Transactions (cont.)

Input VAT considerations

- Following the transfer of business as per above, the taxable recipient replaces the transferee with regards to the right to deduct or refund input VAT related to the transferred business, including making adjustment to input tax previously declared by the supplier.
- Input VAT on costs incurred by the Transferor in relation to the qualifying transfer will be deductible in accordance with the proportion of the overall economic activity of the transferor using the applicable proportional deduction method. This means that if the transferor's recovery ratio is 100%, then input VAT on costs in relation to the transfer will also be fully recoverable.
- In relation to capital assets forming part of a qualifying transfer, input VAT needs to be monitored. Given that the transferee assumes the transferor's position, this means that if there are three remaining years in the adjustment period for the transferor, there will also be three further years for the transferee.

Other key impacts of a qualifying transfer

- The transferee must ensure that he obtains all business records relating to the transferred activity which are required to be retained under KSA Law.
- If a taxable person requires an approval from ZATCA to apply a certain scheme, the transferee needs to apply for that approval himself: any existing approval in the name of the transferor is not deemed to pass to the transferee. Similar is the case for any rulings.
- The qualifying transfer of the economic activity shall not result in the



Regulations Governing TOGC Transactions (cont.)

transfer of the supplier's tax identification number to the recipient. The recipient shall submit a registration application to the Authority and obtain a tax identification number of his own – if not already registered.

- ZATCA can retrospectively request the transferee to pay VAT and penalties due, in case the transferee considered the economic activity as qualifying; however it was later found out that transferred assets were not used for the same economic activity by the transferee.
- Transfers within the VAT group is out of scope of VAT by default – irrespective of whether the conditions are fulfilled or not. However, it is a good practice to ensure that TOGC conditions are also complied with – as a second line of defense should there be any challenge to the veracity of the VAT group.

Some practical considerations/ challenges

- The taxable recipient is allowed to deduct or refund the input VAT in relation to the transferred business. However, there may be administrative challenges such as invoices not being in the name of the recipient – which is likely to be challenged by the ZATCA.
- It has been provided that the recipient shall not replace the transferor with respect to the transferor's liability for tax violations committed before the date of the transfer and related to the goods and services that are the subject of the transfer. Practically, if the transferor ceases to exist, then liability may still potentially be on the transferee.
- Intention to continue the same economic activity - The buyer must demonstrate intention to operate the business as a going concern. This could be challenging and tricky in certain circumstances in view of



Regulations Governing TOGC Transactions (cont.)

lack of clear guidance around this matter. For example, there is a very famous case UK case (Houshang Tahmassebi (t/a Sale Pepe) [1996] BVC 4,088), wherein an Indian restaurant was transferred to a person who then ran an Italian restaurant there. The TOGC treatment was challenged by the tax authorities on the grounds that same economic activity has not been continued. TOGC treatment was upheld by the Tribunal later on. However, this case does highlight that a number of practical issues could arise, especially when the law/ guidelines are not very explicit in this respect.

Real Estate Transaction Tax (RETT)

If a transfer of business includes real estate property, the transaction is subject to RETT at a rate of 5% based on the market value of the property. This is irrespective of the fact that the transfer is exempt from a VAT perspective. There is no such relief from a RETT perspective.

However, the RETT regulations so provide some exemptions for business restructurings, including:

- Intra-group transfers: Property transfers between entities with 100% common ownership are exempt, provided the ownership remains unchanged for at least five years. Note that while VAT group can be formed where 50% ownership is common, for RETT relief 100% common ownership is required at the time of transfer and is subject to a 5-year clawback period.
- In-kind contributions: Real estate contributed as an in-kind share to a Saudi company's capital may be exempt if the shares are held for five years and audited financial statements are maintained.



Regulations Governing TOGC Transactions (cont.)

Other important considerations – CIT/Zakat/Transfer pricing

- TOGC transactions are taxed as per the normal CIT laws and Zakat regulations. Any gains realized on TOGC transactions would generally be subject to Zakat at 2.5778% for Saudi and GCC shareholders on their share of the Zakat base. Non-GCC shareholders will be subject to income tax at 20% on their share of taxable income. Nevertheless, where the transfer involves the entire business of a wholly owned GCC entity, there may be scope to structure the transaction in a manner that optimizes the Zakat position.
- Transfer Pricing (TP) considerations become relevant where a TOGC occurs between related parties, such as in intra-group reorganizations or internal business restructurings. Under the KSA TP Bylaws, the applicability of transfer pricing provisions is contingent upon the existence of a related-party relationship and undertaking transactions with such related party (ies). It is therefore critical to assess whether entities involved in a transaction qualify as “related parties” under the Bylaws, either by virtue of ownership interests (Step A) or through the ability to exercise effective control over management or decision-making processes (Step B). The transfer of the business undertaking including tangible assets, goodwill, customer relationships, and other intangibles must be carried out at a value that reflects what independent parties would agree under comparable circumstances. Where the transfer takes place at an undervalue or overvalue, the tax authority may make transfer pricing adjustments to align the consideration with the arm's length value.

Mitigation of tax Exposure in TOGC

TOGC involves the transfer of a business lock stock barrel. This implies that the buyer assumes liabilities along with assets, creating risks of inheriting pre-existing tax or debt obligations. Some liabilities may be identifiable at the time of executing the transaction, while others may arise as unpleasant surprises in the following years.

Where the parties are unrelated, it is extremely important for the recipient to know the quantum/extent of liabilities at the time of executing agreements and negotiate accordingly. This helps to mitigate the potential exposure in TOGC transactions.

To protect their interests, buyer/recipient should employ a multi-layered mitigation strategy as discussed below.

Due Diligence

Buyers must conduct a thorough due diligence that extends beyond basic audited financials. Due diligence analyses the financial, legal, tax, and operational health of a business undertaking being transferred. It ensures that the valuation is justified, provides an assurance of regulatory compliance and identifies hidden liabilities, if any.

Mitigation of tax Exposure in TOGC (cont.)

Contractual Protections

Any TOGC transaction must be executed by way of a robust agreement with clauses for indemnification and representation and warranties. Though these are standard clauses in every agreement, they play a very important role when the parties are in dispute at a future date. For instance, the indemnification clause requires the seller to compensate the buyer for any liabilities arising from conduct prior to the closing date and is effective for a specific number of years.

Operational and Insurance Solutions

Post-closing, buyers can mitigate potential liabilities by re-branding and re-executing personnel contracts and customer and vendor agreements. This solution often involves an operational cost and the possibility of losing out customers and vendors. If necessary, it must be implemented deftly with the support of all stakeholders.

Finally, buyers can also seek insurance solutions as an additional layer of financial security if the seller is unable to fulfill indemnity obligations.

Conclusion

In simple terms, a TOGC transaction must be commercially sound. The goodwill, brand, people, customers, and vendor relationships acquired should justify the business decision. Potential exposure to liabilities can be mitigated through appropriate contractual and structural safeguards, as discussed above.

Saudi Arabian law also offers meaningful tax efficiencies, particularly under VAT provided the TOGC conditions are strictly met. The onus rests on the parties, primarily the recipient, to ensure robust documentation is in place to demonstrate satisfaction of the conditions and continuity of the business activity.

Further, where the transfer involves the entire business of a wholly owned GCC entity, there may be scope to structure the transaction in a manner that optimizes the Zakat position.



OUR TEAM

UAE CONTACTS

NIMISH GOEL
Leader, Middle East
nimish.goel@dhruvaadvisors.com
Tel (UAE): +971 50 106 6531
Tel (KSA): +966 54 760 1600

GEET SHAH
Partner
geet.shah@dhruvaadvisors.com
Tel: +971 50 106 9034

KAPIL BHATNAGAR
Partner
kapil.bhatnagar@dhruvaadvisors.com
Tel: + 971 50 868 36207

RAKESH JAIN
Partner
rakesh.jain@dhruvaadvisors.com
Tel: +971 50 135 2319

SANDEEP KUMAR
Partner
sandeep.kumar@dhruvaadvisors.com
Tel: +971 50 504 8787

UJJWAL KUMAR PAWRA
Partner
ujjwal.pawra@dhruvaadvisors.com
Tel: +971 50 199 3363

VLAD SKIBUNOV
Partner
vlad.skibunov@dhruvaadvisors.com
Tel: + 971 54 404 0510

FRAN WILHELM
Associate Partner
fran.wilhelm@dhruvaadvisors.com
Tel: +971 58 152 8008

SHIRAZ SALEEMI
Associate Partner
shiraz.saleemi@dhruvaadvisors.com
Tel: +971 50 660 2520

KSA CONTACTS

MANISH BANSAL
Associate Partner
manish.bansal@dhruvaadvisors.com
Tel: +966 54 645 0681

GOPAL AGARWAL
Director
gopal.agarwal@dhruvaadvisors.com
Tel: +966 54 806 9633

DUBAI

204, Emaar Square,
Building 4, PO Box 127165,
Dubai, UAE
Tel: + 971-4240-8477

ABU DHABI

1905, Addax Tower City of
Lights, Al Reem Island, Abu
Dhabi, UAE
Tel : +971-2678-0054

SAUDI ARABIA

308, 7775 King Fahd Road,
Al Olaya, 2970, Riyadh 12212,
Saudi Arabia



www.dhruvaconsultants.com

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