

16 September 2015

Virtual Service Permanent Establishment – Saudi Arabia Developments

Overview

Recent news that the Department of Zakat and Income Tax (“DZIT”) has issued internal guidelines on withholding taxes refunds that introduce the concept of a “Virtual Service Permanent Establishment” has created concern amongst companies doing business with Saudi Arabia and a sense of *deja vu* for experienced professional advisors. Not only is the Virtual Service PE contrary to the Saudi income tax law, the tax treaties Saudi Arabia has signed, and the generally accepted international practice; it seems to be a return to the pre-tax reform years when an arbitrary and sometimes capricious DZIT invented tax law through confidential unpublished internal guidelines. In our view, the DZIT will not be able to sustain this policy as it is clearly contrary to the long term public interest of the Kingdom, but in the short term, companies should consider protective measures in such areas as contractual tax clauses and how services are delivered to Saudi Arabia.

Discussion

The internal guidelines state that a Virtual Services PE is created when a non-resident service provider furnishes services in connection with another person’s activity in the Kingdom for a period of at least 183 days (or whatever threshold is provided by an applicable tax treaty). No physical presence or delivery within the Kingdom is necessary to create a Virtual Services PE.

As a consequence of these guidelines, tax treaty claims for an exemption or refund of withholding tax for service payments may be refused. Domestic tax law general provides for 5% withholding tax on service payments but this rises to 15% on payments to a related party. Tax treaties generally reduce this to nil withholding tax. The service provider may then be expected to file tax returns for a PE in Saudi Arabia.

These internal guidelines are clearly contrary to Saudi income tax law that defines a PE as the “permanent place of the non-resident’s activity through which it carries out business” and the OECD

Model Tax Treaty that refers to “a fixed place of business through which the business of an enterprise is wholly or partly carried on”.

The DZIT interpretation appears to arise from recent discussions at meetings of the United Nations Committee of Experts for Tax Cooperation regarding the services provision that is included in the UN Model Tax Treaty in Article 5 (3) (b). This refers to the “furnishing of services including consultancy services, by an enterprise”. A minority view was that “furnishing” was different from “performing” or “rendering” and did not require a physical presence in the recipient country. Although, the primary concern of this minority was “cyber-based technical services” delivered “through the network” rather than general offshore technical and consultancy services as proposed by the DZIT.

However, this minority view was rejected by a large majority of the Committee of Experts and the UN continues to take the same position as the OECD that a physical presence within the country is required for a PE to exist.

It may be noted that whilst many of the Kingdom’s tax treaties follow the UN Model Tax Treaty, the older tax treaties are closer to the OECD Model Tax Treaty.

The internal guidelines appear contrary to a public policy of encouraging foreign partnership with the Kingdom (particularly for providing new technical knowhow) by continued liberalisation of the commercial law for foreigners and a sharp increase in the number of double tax treaties and other investment treaties being signed. They also appear to be contrary to the intent of the Saudi tax reform in 2004, which introduced a comprehensive tax law and publicly available regulations and guidelines to replace the prior practice of using confidential unpublished internal guidelines to direct tax policy.

What may companies do?

In the short term, service providers and their clients are likely to be challenged by DZIT for any claim/ refund for tax treaty relief for withholding tax. Accordingly, companies should factor in the potential tax cost in their pricing or the tax indemnity clauses of a contract. In some cases, it may be possible to restructure how services are delivered to mitigate the exposure. There is also the option to challenge the DZIT’s position by appeal to the First Instance Committee (tax tribunal) and the Mutual Agreement Procedure of a tax treaty. However, we do believe that in the longer term, the DZIT will have to revise this new policy in the light of criticism from major companies wishing to provide much needed technical and expert services to the Kingdom and when both the OECD and UN restate their views that physical presence is a fundamental requirement for a PE to exist.

For further information, please contact The Cragus Group: contact@cragus.com.