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Saudi Arabia plays safe on reform

New Saudi tax reforms attempt to balance the need for alternative sources of income with the desire for more foreign investment in the private sector.

Foreign investors may have looked forward optimistically to less discrimination and more certain application as Saudi Arabia reformed its tax regime. But if others in the region follow its example, more of the same is the only sure thing. By Bob Peake, UAE

Saudi Arabia's economy, like that of several of its Gulf neighbours, continues to be dependent on oil revenues. Such revenues provide about three-quarters of government income in an economy dominated by government expenditure. This has raised a number of concerns. First, the economy is vulnerable to fluctuations in the oil price, for example it was badly affected in 1998 when the price per barrel fell below $10. Second, even with rising oil prices, the government continues to be in deficit on annual expenditure. Third, the economy is not growing in real terms, with a small non-oil private sector. Finally, there is insufficient growth in job creation to employ the growing number of young Saudis completing their education. Similar concerns face some of the neighbouring states.

Another important factor in Saudi Arabia's reforms is the negotiations for entry into the World Trade Organization. Saudi Arabia hopes to be a member of the WTO before the end of the year 2000. To gain membership, it needs to satisfy the WTO in a number of areas. The country has just introduced a new Foreign Capital Investment Regulation. Together with proposed reforms to the tax law, these two measures may be seen as the government's attempt to balance the need for another source of revenue whilst encouraging growth of the private sector through foreign investment.

Encouraging foreign investment

The Foreign Capital Investment Regulation introduces several changes, in addition to the promise of a simpler and quicker licensing procedure for foreign investors. Responsibility for issuing licences is with the General Investment Authority (GIA). Unlike its predecessor, the Foreign Capital Investment Committee, the GIA is expected not to deliberate in secret and will have to give reasons for refusing a licence application. The GIA has to settle any application for a licence within 30 days of submission of requested documents and the applicant has the right of appeal.

Foreign investors will be allowed to invest in any sector unless specifically excluded. Under the old rules, they were prohibited from all types of investment unless expressly allowed. Foreigners will have greater freedom to own real estate. Further, 100% foreign ownership of Saudi businesses should be allowed in practice, and generally treated equally with Saudi-owned businesses in obtaining government grants, soft loans and government contracts.

Before the new regulation, it was legally possible to have a wholly foreign-owned company established in Saudi Arabia. However, such a company was rarely granted a licence to do business. Furthermore, a minimum 25% holding by Saudi nationals was a requirement to qualify for a tax holiday. In practice, it was common for companies to be held 51% by nationals and 49% by foreigners before a licence would be issued.

The Saudi liberalization of foreign investment is mirrored by proposed changes in other Gulf states. For example, a draft investment law in Kuwait would permit the Ministry of Commerce and Industry to grant a licence to a 100% foreign-owned Kuwait company. At present, foreign ownership is restricted to 49%. Similarly, Qatar is considering allowing foreigners to take majority holdings in companies operating in certain sectors, including health and tourism.

It is undoubtedly the case that foreign investors have tried to avoid the restrictions on foreign ownership by operating through companies wholly owned by nationals. However, these so-called

'sleeping partner' arrangements are illegal in Saudi Arabia. Foreigners using such arrangements, and those assisting them, may be subject to fines and even imprisonment.

Saudi Arabia's tax system

To appreciate the implications of the proposed Saudi tax reforms, it is important to understand the existing tax system and some of its unusual features. As with neighbouring states, Saudi tax legislation is extremely brief compared to, for example, the tax legislation of the US and most European countries. Various decrees, regulations and circulars have supplemented the legislation.

However, in the absence of a codified law, the application of tax law is open to different interpretations. Whilst there have been attempts to standardize the Department of Zakat and Income Tax's treatment of certain tax issues, differences can be observed between the tax offices and the tax inspectors. However, the position is not as extreme in Kuwait, where the legislation is shorter and largely interpreted through internal Department of Income Tax regulations, which are not publicly issued.

The tax system has two essential characteristics. First, income tax is only payable by foreigners on their share of business profits. Business profits accruing to Saudi nationals and Gulf Cooperation Council (GCC) nationals (the GCC consists of Saudi Arabia, Kuwait, Bahrain, Qatar, Oman and the UAE) are subject to the religious wealth levy or zakat. Second, whilst tax is only assessed on Saudi source income, the interpretation of what is considered to be Saudi source is widely defined.

Saudi companies with foreign shareholders are subject to corporate income tax to the extent that profits belong to the foreign shareholders in accordance with the memorandum and articles. The rate of tax for companies varies from 25% to 45% with the highest rate applied to profits of more than SR1 million ($270,000). Permanent establishments of foreign companies are subject to corporate income tax. Tax is also applied to foreign individuals in receipt of self-employed income or who have an interest in a non-corporate business entity, such as partners in a professional partnership. The individual income tax rates are 5%-30% (the highest rate applies to income of more than SR66,000) with a tax-free allowance of SR6,000 each year. There is no tax on wages and salaries.

There are close similarities between the Saudi tax system and the tax systems of Kuwait and Qatar. For example, in Kuwait tax is only imposed on foreign companies doing business in Kuwait through a permanent establishment or by holding shares in a Kuwait company. The highest tax rate is 55%. Oman differs in that all business entities, both foreign and Omani-owned, are subject to the corporate income tax. However, the rates of tax vary according to the level of foreign participation. Thus, entities with at least 51% Omani participation are taxed at 12%, whilst other entities are generally taxed at rates up to 25% (although the rate is 50% for branches of foreign companies).

The tax basis in Saudi Arabia is largely based on the accounts, with some tax adjustments. Of the latter, there are three points of note. First, in contrast to Kuwait, Qatar, and Oman, Saudi Arabia does not provide for the carryforward of tax losses. Second, there is a disallowance for allocation of head office costs or indirect expenses. This contrasts with the neighbouring countries where limited deductions are available. For example, in Kuwait deductions between 2%-3.5% of revenue can be taken as an allowance for head office expenses. Third, any payments in respect of foreign social insurance or foreign employee pension plans cannot be deducted. Additionally, the compulsory end of service benefits paid to employees is only deductible when actually paid and not when provided for.

As already noted, the definition of Saudi source income is widely interpreted. For example, the leasing of equipment, and the briefest of visits to perform onshore technical or professional services, can create a taxable presence. The last point is particularly important and can result in an unexpected tax burden for foreign companies providing services to Saudi businesses.

The basic principle is that services wholly provided offshore are not subject to tax, whilst services partly or wholly performed in Saudi Arabia are taxable in full. This can mean that even where the greater part of the contract value relates to the offshore element, the whole contract can become taxable because of relatively low-value activity performed in Saudi Arabia. This has led to the

practice of split contracts, with separate contracts for the offshore and onshore elements. However, the tax authorities are becoming increasingly vigilant and may try to treat obviously related contracts as if they formed one contract.

Another area of common confusion for foreign companies is that they may be considered taxable in Saudi Arabia simply by virtue of receiving a payment from a Saudi source. The resulting tax liability is often referred to as a withholding tax, but there are important differences from the withholding taxes commonly found in the US and Europe.

Where a foreign company receives Saudi source payments but does not have a permanent presence in Saudi Arabia, the payer is held responsible for the tax liability of the recipient. This effectively means that the payer should withhold the tax due. The tax liability is based on a deemed profit, which varies depending on the nature of the payment. Whilst the deemed profit must be at least 15%, it can be as high as 100% on royalties and management fees. Unfortunately, there is no certainty over the level of deemed profit that the tax authorities may consider appropriate.

The final level of deemed profit is often subject to negotiation at the time the payer submits a tax or zakat return. Furthermore, there are no clear definitions of what constitutes a particular type of payment. For example, there is a tendency to treat any payment measured as a percentage of revenue or profit as a royalty without regard to what the payment is actually for.

Although there are important differences in detail, the wide definition of taxable presence and income found in Saudi Arabia is also found in neighbouring states such as Kuwait.

A final element of the previous Saudi tax system worthy of note was the existence of tax holidays provided for in the old Foreign Investment Law. Several conditions had to be met, but in general terms, 10-year tax holidays were available for industrial and agricultural activities and five-year tax holidays for other activities. A further tax holiday was also available for profits attributable to future capital expansion. The tax holiday did not apply to offshore payments, and a company benefiting from a tax holiday was still responsible for the tax payable in respect of payments for technical services, royalties, management fees etc.

The proposed tax reforms

Details of the tax reforms have not yet been published. They may be subject to some delay and it seems that there have been a number of last minute changes. What is clearly emerging is that the final reforms will not be as radical as first indicated.

Early proposals included introducing corporate and personal income tax for Saudi-owned companies and Saudi individuals for the first time. One proposal was that all companies, without regard to the shareholding, would have been subject to a flat tax rate of 15%. The only distinction to be made in respect of the shareholders was that there would be a dividend withholding tax introduced at the rate of 5% for dividends paid to Saudi residents and 15% for dividends paid to non-residents. Perhaps even more radical was the proposal to introduce personal income tax for both Saudi and foreign individuals at the rate of 15%. For income other than salaries and wages earned by foreign employees, there would be a tax exemption for the first SR60,000 of annual income.

Other early proposals of note were that business losses could be carried forward until fully absorbed. Additionally, there would be a major overhaul of the system for taxing payments to foreigners. Instead of the current system of taxing a deemed profit at normal tax rates, a true withholding tax system would be introduced. Suggested rates were 5% on insurance premiums, loan interest, and payments against air tickets, air cargo, marine cargo and communication services. 15% was to be applied to all other payments except 20% on rent, royalty and management payments.

The latter proposal was a mixture of good and bad news. The 15% rate was much higher than the effective tax rate on onshore technical services that typically varies between 7% and 9%. However, the effective tax rate on royalty and management fees can be as high as 45%. A further improvement would be the greater certainty over the level of tax to be paid, as there would no longer be the question of the tax authorities determining the appropriate level of deemed profit.

Some early reports of the new Foreign Capital Investment Regulation also suggested that the system of granting tax holidays would be changed, so that there would be a uniform tax holiday of 10-15 years available for all types of activities.

It now appears that many of these early proposals have been set aside. Apparently, the proposal to subject Saudi individuals to income tax has been dropped, and personal income tax may only be assessed on highly-paid expatriate workers in respect of their salaries. Rather than reduce the corporate tax rate, the government will give a 15% tax rebate (reducing the effective tax rate to 30%) where business profits exceed SR100,000.

To date, no information has been given about the procedure for claiming and receiving the rebate. Profits below this amount will continue to be taxed at the marginal rate of 25%. This will apply to Saudi companies wholly owned by foreigners and to the business profits attributable to foreign shareholders in Saudi companies with Saudi and foreign shareholders. It is not clear whether foreign companies operating in Saudi Arabia through a branch will also be entitled to the rebate. There is no indication of whether any taxation will be levied on wholly-owned Saudi companies or on the profits attributable to Saudi shareholders.

It has been confirmed that losses may be carried forward, although there have been suggestions that this may be subject to some conditions. This concession has been offset by an abolition of tax holidays, although it is understood that existing tax holidays will be allowed to continue for their complete term. It also remains to be seen whether the treatment of offshore payments will be replaced by a more conventional withholding tax system.

Assessment of tax reforms

The combination of the new foreign investment law and the tax reforms has been heralded as a major encouragement for foreign investment. It has been further claimed that the equal treatment of foreign companies in obtaining government contracts and other benefits such as concessionary state finance will mean that foreigners will no longer be tempted to enter into arrangements with a Saudi 'sleeping partner'. However, the apparent continuation of a discriminatory tax system does seem to contradict moves to open up the Saudi market to foreign investment in the context of the WTO negotiations.

Whilst the effective reduction in corporate income tax is to be welcomed, it is not the major reduction previously being contemplated. A rate of 30% merely brings, at best, Saudi Arabia in line with most investor countries rather than providing an incentive. Indeed, if the current disallowance of certain costs continues, the effective tax rate may continue to be higher.

One of the interesting aspects of the earlier proposals was the apparent encouragement for foreigners to reinvest profits by having a low corporate income tax rate combined with a relatively high dividend withholding tax. Furthermore, if there is continued tax discrimination against profits belonging to foreign investors, there is clearly a continued incentive for some investors to structure their Saudi activities through the use of 'sleeping partners'.

A final observation on the tax rate is that details of how the rebate system will work have not been released. It is not immediately apparent why this rebate system was adopted, rather than simply reducing the tax rate to 30%.

The taxation of highly-paid expatriate salaries is likely to become a hidden tax on foreign companies. Most expatriates work in Saudi Arabia in the expectation of receiving reasonable levels of tax-free income. To retain such employees, many companies will find themselves having to increase salaries to compensate for the income tax. This will be an absolute cost without even the possibility of obtaining a foreign tax credit in those countries which have a tax credit system. It may be the government's view that this will encourage the employment of Saudi nationals, but it is unlikely to have such an impact. An option for the government might be to provide loans, grants and tax incentives specifically designed to encourage the private sector to undertake job training programmes for Saudi employees.

Whilst the abolition of tax holidays may be surprising in the context of encouraging foreign investment, the carryforward of losses helps to mitigate this. One of the problems of the five-year tax holidays was that they were often effective for fewer years. A company with start-up losses which could not be carried forward often found that, by the time significant profits started to come online, the tax holiday was due to expire. There was also the view in some Saudi circles that tax holidays had the effect of simply shifting tax revenues from Saudi Arabia to the investor countries. However, initial reaction by foreign investors to the end of tax holidays will not have been encouraging to the government.

One of the major tax concerns for foreign companies doing business in Saudi Arabia are the uncertainties in the application of the tax system, and the arbitrary disallowance of certain costs. This should be an important aspect of any tax reform. It is to be hoped that the tax reforms will introduce a new withholding tax regime. It is clearly better to have fixed withholding tax rates rather than the uncertainties of a deemed profit basis. However, the previously proposed levels of withholding tax should be carefully reconsidered if foreign companies are to be encouraged to contribute technical expertise and services. The proposed level of withholding tax on royalties and management fees is obviously more satisfactory than the current effective tax rate of 45%. It is hoped that there will be clearer definitions of what constitutes, for example, a royalty.

Another area of uncertainty to be addressed is the question of what constitutes a taxable presence in Saudi Arabia, and how the income attributable to that presence should be calculated. For example, the temptation for foreign companies to use split contracts could be removed if there was a clear method of only taxing income properly arising from in-country activities. Additionally, there does seem to be the need to allow a deduction for properly allocable head office overheads and indirect expenses. Indeed, companies providing specialist services, IT systems and software solutions do find it a disincentive to do business in Saudi Arabia, because they cannot obtain adequate tax deductions for much of their offshore expenditure.

It can be seen that the tax reforms are an attempt to complement the encouragement of new foreign investment, even if the reforms are not as radical as initially hoped. It is not clear how these reforms fully address the government's need to increase its non-oil revenues. Additional tax will be raised if increased foreign investment takes place. The reduction in the tax rate may encourage foreign companies to pay tax rather than find ways to reduce or avoid it. The taxation of highly-paid expatriates will also bring in some additional revenue. However, it is unlikely that any of this will be significant compared to the revenues that might have been generated had Saudi nationals been brought into the tax net. Presumably, there were wider concerns that persuaded the government not to pursue this.

Concluding remarks
There seems to be a general view held in Saudi Arabia and the region generally that a key element for the encouragement of foreign investment is to reduce the corporate income tax rate. Whilst any reduction in the excessive rates of Saudi Arabia and Kuwait would be a start, such a change is insufficient to address foreign companies' concerns about investing in these countries.

Tax reform should also include an overhaul of the application of the tax system. This includes dealing with many of the uncertainties with specific legislation or published regulations, rather than relying on the interpretation of internal practices or individual inspectors. Additionally, the advantages of any reduction in the corporate tax rate for foreign investors will be cancelled by the introduction of personal income tax and additional social security costs on expatriate salaries, a cost that in many cases will be borne by the employer. Finally, it is not possible to claim that foreign investors are on an equal footing with local businesses as long as a discriminatory tax system continues.

Tax Reforms in other Gulf countries

There are proposals to introduce changes to the Kuwait tax system, although it is uncertain when these are likely to be enacted. The main features are a reduction of the highest tax rate from 55% to 30%-35%, and the introduction of 7-10-year tax holidays. The latter is an interesting contrast to the Saudi decision. These changes are to be combined with the new investment law mentioned

above to encourage foreign investment. However, there is no indication of any attempt to address some of the main tax concerns of foreign companies.

One concern is the requirement of any foreign company receiving payments from Kuwait to file a tax return. There is no provision for a withholding tax system and this puts a tax compliance burden on companies who have no physical presence in the country. Another concern is the brevity of the tax legislation and the lack of certainty over the Department of Tax's interpretation of its limited provisions. Finally, there have been repeated rumours that an income tax will be introduced for expatriate salaries, and recently a new social security cost for expatriate employees was introduced.

Oman last introduced changes to its tax system in 1999. In addition to the variation of tax rates according to the level of Omani ownership, another important feature is a withholding tax regime introduced in 1996. A 10% withholding tax is applied on certain payments to foreign companies if the latter do not have a permanent establishment in Oman. There are five categories of such payments: royalties, equipment hire, management fees, fees for the transfer of technical know-how, and research and development. Further reform may be expected.

No proposals for tax changes in Qatar have been announced to date.