30 April 2020

Global Tax Alert

Saudi Arabia: MLI enters into force on 1 May 2020

EY Tax News Update: Global Edition

EY's Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Also available is our EY Global Tax Alert Library on ey.com.

Executive summary

Saudi Arabia deposited its instrument of ratification for the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the Multilateral Instrument or MLI) with the Secretary-General of the Organisation for Economic Co-operation and Development (OECD) on 23 January 2020.

The MLI will enter into force for Saudi Arabia on 1 May 2020 and 14 Saudi Arabian double tax treaties will be modified as of that date. As more jurisdictions are expected to proceed with ratification of the MLI, going forward, other Saudi Arabian double tax treaties will be amended in line with the MLI. Accordingly, businesses operating in Saudi Arabia should review the changes introduced by the MLI to determine if the changes will affect access to treaty benefits.

Detailed discussion

Background

The OECD and G20's Base Erosion and Profit Shifting (BEPS) Action Plan, established in 2013, represents a package of measures that governments should implement to address features of tax regimes that facilitate BEPS. The Plan has 15 actions, of which four are minimum standards that all Inclusive Framework members, including Saudi Arabia, have committed to implement:

Building a better working world

Action 5 (Harmful tax practices), Action 6 (Prevention of tax treaty abuses), Action 13 (Country-by-Country Reporting) and Action 14 (Mutual Agreement Procedures).

The implementation of BEPS Actions 6 and 13 require the amendment of tax treaties. Currently, the global tax treaty network is comprised of more than 3,000 treaties and amending these through bilateral negotiations would be a cumbersome and time-consuming process. The plan set forth by the OECD/G20 is in BEPS Action 15 via the MLI, which allows governments to modify existing treaties in a synchronized and efficient manner to implement the BEPS measures.

For a tax treaty to be amended by the MLI, both treaty counterparties must be signatories of the MLI and must indicate the tax treaty as a Covered Tax Agreement (CTA). If this is the case, the MLI provisions, limited by the jurisdictions' reservations and choices of optional provisions, will be applied alongside the provisions of the existing bilateral treaty once the MLI is ratified by both jurisdictions.

The MLI enters into force for Saudi Arabia

Saudi Arabia signed the MLI on 18 September 2018, submitting its preliminary list of reservations and notifications (MLI positions).[1] Among these are the minimum standards that must be applied by all signatories of the MLI, including:

- Adoption of a new preamble that updates the objectives of tax treaties to state that a treaty should not be used to "create opportunities for non-taxation or reduced taxation through tax evasion or avoidance" (Article 6 of the MLI)
- Prevention of treaty abuse by including the principle purpose test clause or the limitation of benefits clause (Article 7 of the MLI)
- Inclusion of additional wording in the treaty to improve the dispute resolution process by allowing taxpayers to initiate the Mutual Agreement Procedure to resolve treaty conflicts (Article 16 of the MLI)

At the time of signing the MLI, Saudi Arabia submitted a list of 53 double tax treaties to be designated as CTAs and amended through the MLI. The list includes all 44 double tax treaties that Saudi Arabia has in force, as well as 9 treaties that had not entered into force at that time.

Subsequently, on 23 January 2020, Saudi Arabia deposited its instrument of ratification, including its definitive MLI positions as well as the final list of CTAs. Accordingly, the MLI will enter into force for Saudi Arabia on 1 May 2020.

For its final list of CTAs, Albania and Mauritania were added, increasing the number of CTAs for Saudi Arabia to 55. The provisions of the MLI would have effect as of 1 May 2020 with respect to the CTAs with the following jurisdictions: Cyprus, France, India, Ireland, Japan, Luxembourg, Malta, Netherlands, Poland, Russia, Singapore, Sweden, Ukraine and the United Kingdom. This list will increase as further treaty partners deposit their instruments of ratification. Modification of Saudi Arabia's tax treaties will depend on the final positions adopted by other countries.

Regarding its final MLI position, for the most part, Saudi Arabia maintained its initial positions, except for the following:

- Article 5 (Application of Methods for elimination of Double Taxation): Notifications have been removed and a reservation added.
- Article 9 (Capital Gains from Alienation of Shares or Interests of entities Deriving their Value Principally from Immovable Property): Notifications have been removed and a reservation added.
- Article 17 (Corresponding Adjustments): Reservation has been removed and a notification added.

For an MLI provision to affect a CTA, it should be adopted by both contracting states. In practice, this means that each of the contracting states should indicate in their MLI position that they are adopting a particular provision.

Importance of the MLI for businesses operating in Saudi Arabia

The Saudi Arabian Government's commitment to implement the BEPS minimum standards will help to strengthen the country's business and investment environment. While implementing robust measures to prevent tax avoidance and erosion of tax base, the MLI aims to improve dispute resolution procedures, giving the taxpayer greater protection against inconsistent approaches applied by jurisdictions.

Multinational groups operating in Saudi Arabia need to assess the impact of the major changes brought about by the MLI, such as:

- The introduction of a principal purpose test (PPT) and how this may affect treaty protection relating to withholding tax on payments from a Saudi Arabian source (e.g., dividends, loan fees and royalties). The PPT looks at the principal purpose of transactions or arrangements. If it is reasonable to conclude, considering all relevant facts and circumstances, that one of the principal purposes of that transaction or arrangement is to obtain treaty benefits, these benefits may be denied unless it is established that granting these benefits is in accordance with the object and purpose of the provisions of the treaty.

- Saudi Arabia's adoption of all the MLI provisions relating to the artificial avoidance of permanent establishment (PE) status may result in PEs being recognized in Saudi Arabia through business arrangements that traditionally have not given rise to PEs.

Such changes will be particularly relevant to multinationals receiving Saudi Arabian-sourced income or involved in transactional and investment activity concerning Saudi Arabia. For example, a restriction of the number of exceptions as to what can be considered preparatory and auxiliary activities in the context of a PE or how bifurcation of activities or contracts may be challenged by anti-fragmentation rules.

Businesses operating in Saudi Arabia need to consider the effect of the MLI on their international operations and assess whether their structures comply with the new, stricter standards required to apply bilateral tax treaties. Businesses should review their operational requirements and determine whether new business models should be adopted. It is important to review outbound foreign investment models where Saudi Arabia acts as a holding and/or a hub location and monitor the approach of Saudi Arabia's tax treaty partners to the application of the PPT.

A wider appreciation of the global tax landscape and how BEPS concerns are addressed by other jurisdictions is key to doing business going forward. The principal purpose of business structures should be closely aligned with the functional profile of the entities therein. The connection to the group's transfer pricing (TP) policies and documentation should be considered given Saudi Arabia's recent introduction of TP Bylaws, documentation requirements and Country-by-Country Reporting rules.[2]

The MLI should also improve the Mutual Agreement Procedure (MAP) process in Saudi Arabia. It is expected that MAP cases will become more common in Saudi Arabia.

Endnotes

1. See EY Global Tax Alert, *Saudi Arabia signs Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, dated 2 October 2018.
2. See EY Global Tax Alert, *Saudi Arabia's Tax Authority releases final transfer pricing bylaws and FAQs*, dated 11 March 2019.

For additional information with respect to this Alert, please contact the following:

Ernst & Young & Co (Public Accountants), Riyadh

- Asim J. Sheikh, *KSA Tax Leader* asim.sheikh@sa.ey.com
- Barry Magill barry.m@sa.ey.com
- Esraa Albuti esraa.albuti@sa.ey.com

Ernst & Young & Co (Public Accountants), Al-Khobar

- Syed Farhan Zubair farhan.zubair@sa.ey.com
- Ali K Khamis ali.k.khamis@sa.ey.com

Ernst & Young & Co (Public Accountants), Jeddah

- Hussain Asiri hussain.asiri@sa.ey.com
- Irfan Alladin irfan.alladin@sa.ey.com

Ernst & Young LLP (United States), Middle East Tax Desk, New York

- Asmaa Ali asmaa.ali1@ey.com

EY | Assurance | Tax | Transactions | Advisory

EYG no. 002661-20Gbl

1508-1600216 NY
ED None

ey.com