

Saudi Arabia signs *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*

NEW! EY Tax News Update: Global Edition

EY's new 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

On 18 September 2018, Saudi Arabia signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the Multilateral Instrument or MLI). Once ratified, the MLI will modify the effect of many KSA tax treaties. For more background on the global significance of the MLI, see EY Global Tax Alert, [68 jurisdictions sign the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS](#), dated 7 June 2017.

Detailed discussion

Background

On 24 November 2016, the Organisation for Economic Co-operation and Development (OECD) released the text of the MLI and explanatory notes. See EY Global Tax Alert, [OECD releases multilateral instrument to implement treaty related BEPS measures on hybrid mismatch arrangements, treaty abuse, permanent establishment status and dispute resolution](#), dated 2 December 2016, for a more detailed analysis of the MLI-related Base Erosion and Profit Shifting (BEPS) measures on hybrid mismatch agreements, treaty abuse, permanent establishment (PE) status and dispute resolution.

On 17 July 2018, the Saudi Cabinet authorized the Minister of Finance to sign the MLI in line with its commitment to comply with the best international standards to eliminate tax evasion and work with the international community in this area.

On 18 September 2018, Saudi Arabia signed the MLI and became the 84th jurisdiction to join the MLI, which is an important step in implementing the minimum standard relating to tax treaty abuse. The MLI now covers over 1,400 bilateral tax treaties.

This Tax Alert focuses on the MLI and on its potential effect for multinationals doing business in Saudi Arabia.

The MLI

One of the BEPS minimum standards (Action 6) involves the prevention of treaty abuse, where taxpayers claim treaty benefits that the treaty countries did not intend to grant. One example is treaty shopping, when a multinational company may establish a passive holding company in a jurisdiction solely to benefit from preferential tax treaty rates available to tax residents in that jurisdiction.

The minimum standard under BEPS Action 6 requires countries to implement rules in their tax treaties that limit the opportunities for treaty abuse. For existing treaties, this would be a problematic exercise if bilateral solutions (i.e., treaty renegotiation) were required. The MLI was developed to address this. The MLI allows a signatory to indicate those of its tax treaties, Covered Tax Agreements (CTAs), to which the MLI will apply. If the treaty partner is also a signatory and identifies the treaty as a CTA, the MLI provisions will be incorporated into the particular bilateral tax treaty once the MLI is ratified by both countries.

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 have not yet entered into force.

Together with the list of CTAs, Saudi Arabia also submitted a preliminary list of reservations and notifications (MLI positions) in respect of the various provisions of the MLI. The definitive MLI positions as well as the final list of CTAs will be provided upon the deposit of its instrument of ratification, acceptance or approval of the MLI.

Effect of the MLI provisions

Many of the provisions of the MLI overlap with provisions found in CTAs. Where the provisions of the MLI conflict with existing provisions covering the same subject matter

in a CTA, this conflict is addressed through one or more compatibility clauses. Compatibility clauses may describe existing provisions that the MLI intends to supersede, or the effect the MLI has on CTAs that do not contain a provision of the same type. Contracting jurisdictions have the right to reserve certain parts of the MLI (opt-out) and to have these specific articles not apply to their tax treaties.

Saudi Arabia has elected not to adopt certain optional MLI positions. Specifically, Saudi Arabia made reservations relating to Article 3 (Transparent Entities), Article 4 (Dual Resident Entities), Article 8 (Dividend Transfer Transactions), Article 10 (Anti-abuse Rule for PEs Situated in Third Jurisdictions), Article 11 (Applications of Tax Agreements to Restrict a Party's Right to Tax its Own Residents) and Article 17 (Corresponding Adjustments).

For issues on which each country must adopt a position, Saudi Arabia has generally adopted the position that has the least effect on CTAs. Many countries have adopted a similar approach. However, there are several MLI positions relating to key issues that have been adopted by Saudi Arabia, such as anti-abuse, PEs and enhancing dispute resolution that could significantly affect the application of Saudi tax treaties.

Treaty abuse

Articles 6 to 13 of the MLI contain six provisions relating to the prevention of treaty abuse that correspond to changes proposed in the BEPS Action 6 final report (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*). In particular, the report contains provisions relating to the so-called "minimum standard" aimed at ensuring a minimum level of protection against treaty shopping (Article 6 and Article 7 of the MLI).

New preamble

The MLI requires countries to adopt a preamble that updates the objectives of CTAs to:

- ▶ Express the common intention to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided for the indirect benefit of residents of third jurisdictions)
- ▶ Desire to further develop their economic relationship and enhance the cooperation in tax matters

Because the preamble forms part of the context of a treaty, the statement and objectives should be taken into account when interpreting provisions of the tax treaty, including anti-abuse rules inserted by the MLI.

Principal purpose test

The main component of Action 6 was to choose between the limitation of benefits (LOB) and principle purpose test (PPT) approach to tax treaty abuse:

- ▶ LOB would limit the availability of treaty benefits to entities that meet certain conditions, based on the legal nature, ownership in, and general activities of the entity.
- ▶ The more general PPT is based on the principal purposes of transactions or arrangements. If one of the principal purposes is to obtain treaty benefits, these benefits may be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.

As Saudi Arabia did not make any reservation, it adheres to the minimum standard by applying the MLI default PPT rule in its CTAs. Going forward, it is expected that most of the country's tax treaties (including those already providing for an existing PPT but only covering specific articles such as dividends, interest and royalties) will be replaced with the broader MLI PPT provision.

The PPT is most likely to affect inbound investment into Saudi Arabia. Where the PPT requirements are met, the preferential tax treaty rate on passive income (such as dividends, royalties and interest) may be denied. Currently, a nonresident investor will generally be able to obtain treaty relief based on demonstrating that it is tax resident in the tax treaty partner jurisdiction of Saudi Arabia. Once the PPT comes into effect, inbound investors may also need to show that tax treaty considerations have not been the driver for the investment structure.

Capital gains deriving their value from immovable property

Article 9 of the MLI incorporates an anti-abuse rule with respect to capital gains realized from the sale of shares of entities deriving their value principally from immovable property. If a CTA already contains a rule that allows capital gains from the sale of shares deriving a specified percentage of their value from real property, Article 9(1) allows that percentage value threshold to be applied at any time during the 365 days preceding the sale. Article 9(1) also allows the rule to apply to shares or comparable interests such as interests in a partnership or trust.

In addition, Saudi Arabia made a notification to adopt Article 9(4), which would allow source taxation of gains from the disposition of shares or comparable interests that at any

time in the preceding 365 days have derived more than 50% of their value directly or indirectly from immovable property, even if the CTA does not contain a similar provision.

Most of the Saudi bilateral tax treaties generally allocate taxing rights with respect to disposals of shares in immovable property-rich companies to the source state, so this MLI provision should reflect the existing source taxation policies of Saudi Arabia.

Artificial avoidance of PE status

The final report relating to BEPS Action 7 identified a number of investment structures that may be used to avoid creating a PE. These structures include commissionaire arrangements, using the preparatory or auxiliary activities exemption for activities that form the core part of an investor's business, and fragmenting construction projects. Articles 12-15 of the MLI introduce provisions into CTAs that address such structures.

Saudi Arabia has adopted the MLI provisions that target the artificial avoidance of PEs.

Commissionaire arrangements and similar strategies

Under the pre-BEPS *OECD Model Tax Convention on Income and on Capital* (OECD Model), an agency PE could potentially arise only if a person habitually exercised an authority to conclude contracts in the name of a nonresident. Under the laws of some countries, this meant it was possible to have a person perform almost all of the work giving rise to a sale without creating a PE, provided the person did not actually sign the contract. Commissionaire arrangements, when a person would sell goods in its own name that another person owned, was one of the specific techniques used.

Article 12 of the MLI will result in an agency PE potentially also arising when a person habitually exercises the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the nonresident.

Under the former OECD Model, an agency PE would not arise if the agent were acting in an independent capacity in the ordinary course of the agent's business. To reduce the potential for abuse, Article 12 also deems a person that is closely related to the nonresident not to be independent of that nonresident.

"Preparatory and auxiliary" activities

The pre-BEPS OECD Model contained an exemption from PE status for a fixed place of business that is used solely for the purposes of activities specified in Article 5(4) of the

Model, including such activities as storage for delivery and representation. The purpose of Article 5(4) was to relieve from taxation and associated compliance costs the low-value support functions that were remote from the core income-generating business of the nonresident. However, this created potential for abuse through fragmentation of activities and by entities whose core profit-generating functions involved the delivery of the activities specified in Article 5(4).

Article 13 of the MLI addresses these concerns. Saudi Arabia chose to adopt the option whereby the Article 5(4) exemption should only be available if the specific activity listed is of a preparatory or auxiliary character. In addition, Saudi Arabia adopted the anti-fragmentation clause, when the Article 5(4) exemption will not apply if the business activities constitute complementary functions that are part of a cohesive business operation.

Splitting-up of construction contracts

Article 5(3) of the pre-BEPS OECD Model stated that a building site or construction or installation project could constitute a PE only if it lasts more than 12 months. This created potential for abuse if more than one related party completed a project, with each party ensuring that its time on the project did not exceed the 12-month period.

Article 14 of the MLI introduces an anti-avoidance rule that will result in the time-test being applied to the aggregate period that related parties are involved in the delivery of a building, construction or installation contract.

Enhancing dispute resolution

Under the standard Mutual Agreement Procedure (MAP) article of current Saudi tax treaties, a person may only initiate MAP through the Competent Authority of the State in which the person is resident.

Article 16 of the MLI allows a person to approach either Competent Authority to initiate MAP. Saudi Arabia has not made a reservation on this provision.

The next steps with respect to the MLI

The MLI entered into force on the first day on the month following the expiration of three calendar months after the fifth jurisdiction deposited its instrument of ratification, acceptance or approval. The fifth country, Slovenia, deposited its instrument on 22 March 2018. Consequently, the MLI entered into force on 1 July 2018.

Saudi Arabia is expected to work towards reviewing and finalizing its preliminary list of CTAs and MLI positions for ratification. Once ratified, Saudi Arabia will deposit its instrument of ratification, acceptance or approval with the OECD.

With respect to a specific bilateral tax treaty (such as those concluded by Saudi Arabia with treaty partner jurisdictions), the provisions of the MLI will have effect after both parties to a CTA have deposited their instrument of ratification, acceptance or approval of the MLI and a specified time has passed. The timing differs for different provisions. For example, for provisions relating to withholding taxes, the entry into force date is the 1 January of the following year after the last party has notified of its ratification.

Implications

The Saudi Government's commitment to implement the BEPS minimum standards will help to strengthen the country's business and investment reputation in the Middle East. Signing the MLI is an important step in the ongoing BEPS process.

Businesses operating in Saudi Arabia should assess the potential implications of the MLI:

- ▶ The MLI may affect tax treaty protection relating to withholding tax on payments from a Saudi source like dividends, loan fees and royalties.
- ▶ Saudi Arabia's adoption of the PE-related MLI provisions may result in PEs being recognized in Saudi Arabia for business arrangements that traditionally have not given rise to PEs.

Businesses should review their operational requirements and the potential level of risk once the MLI is ratified, and determine whether new business models should be adopted.

Beyond ratification of the MLI, businesses investing and operating in Saudi Arabia will need to monitor how the Saudi tax authorities apply the MLI, with particular focus on the anti-abuse measures and PE provisions.

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

Ernst & Young & Co (Public Accountants), Saudi Arabia Tax Leader, Riyadh

- ▶ Asim J. Sheikh asim.sheikh@sa.ey.com

Ernst & Young & Co (Public Accountants), Riyadh

- ▶ Abbet R Barce abbet.barce@sa.ey.com
- ▶ Ahmed Abdullah ahmed.abdullah@sa.ey.com
- ▶ Amr Farouk amr.farouk@sa.ey.com
- ▶ Altaf Sarangi altaf.sarangi@sa.ey.com
- ▶ Hosam Abdulkareem hosam.abdulkareem@sa.ey.com
- ▶ Imran Iqbal imran.iqbal@sa.ey.com
- ▶ Michael Hendroff michael.hendroff@ae.ey.com
- ▶ Mirza Ashraf mirza.ashraf@sa.ey.com
- ▶ Nitesh Jain nitesh.jain@sa.ey.com
- ▶ Parvez Maqbool parvez.maqbool@sa.ey.com
- ▶ Sohail Nini sohail.nini@sa.ey.com
- ▶ Stuart Halstead stuart.halstead@sa.ey.com
- ▶ Suleiman Mohammed suleiman.mohammed@sa.ey.com
- ▶ Vladimir A. Gidirim vladimir.gidirim@sa.ey.com
- ▶ Yousef Eldaw yousef.eldaw@sa.ey.com

Ernst & Young & Co (Public Accountants), Jeddah

- ▶ Franz-Josef Epping franz-josef.epping@sa.ey.com
- ▶ Ayman Abu El Izz ayman.abuelzz@sa.ey.com
- ▶ Hanif Khatri hanif.khatri@sa.ey.com
- ▶ Hussain Asiri hussain.asiri@sa.ey.com
- ▶ Imran Ahmed imran.ahmed@sa.ey.com
- ▶ Irfan Alladin irfan.alladin@sa.ey.com
- ▶ Mohammed Desin mohammed.desin@sa.ey.com

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

- ▶ Syed Farhan Zubair farhan.zubair@sa.ey.com
- ▶ Ali Sainudheen ali.sainudheen@sa.ey.com
- ▶ Bilal Mian bilal.mian@sa.ey.com
- ▶ Hatem Ghobara hatem.ghobara@sa.ey.com
- ▶ Javed Aziz Khan javed.aziz@sa.ey.com
- ▶ Jude deSequeira jude.desequeira@sa.ey.com
- ▶ Sanjeev Fernandez sanjeev.fernandez@sa.ey.com

Ernst & Young LLP, Middle East Tax Desk, Houston

- ▶ Gareth Lewis gareth.lewis1@ey.com

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2018 EYGM Limited.
All Rights Reserved.

EYG no. 011208-18Gbl

1508-1600216 NY

ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com