

Saudi Arabia publishes United Arab Emirates tax treaty

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Executive summary

The Kingdom of Saudi Arabia (Saudi Arabia) and the United Arab Emirates (UAE) signed the first double tax treaty (treaty) between members of the Gulf Cooperation Council (GCC) on 23 May 2018.

On 5 March 2019, the text of the treaty was published in the Saudi Arabian *Official Gazette*, allowing investors to see the provisions of the new treaty.

The treaty broadly follows the United Nations Model Tax Convention (UN MTC), and also incorporates the minimum standard provisions of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the MLI).

Among other benefits, the treaty offers a 0% tax rate on payments from debt-claims, a reduced tax rate on royalties as well as certain exemptions available for income of investments made by sovereign entities (i.e., central banks, sovereign wealth funds and government institutions). The treaty is expected to become effective from 1 January 2020, after completion of all necessary ratification requirements in both the UAE and Saudi Arabia. Businesses should review their Saudi Arabian and UAE operations for opportunities to benefit from the new tax treaty.

Detailed discussion

This Alert summarizes the key features of the treaty and highlights the potential impact on cross-border transactions between Saudi Arabia and the UAE.

Preamble

The preamble adopts the language of Article 6 of the MLI, and indicates that the objectives of Saudi Arabia and the UAE are to further develop their economic relationship and to enhance their cooperation in tax matters, as well as eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion, and tax avoidance including through treaty-shopping arrangements. Because the preamble forms part of the context of the treaty, the statement and objectives should be considered when interpreting provisions of the treaty.

Persons covered (Article 1) and Residents (Article 4)

The scope of the treaty is limited to residents of Saudi Arabia and the UAE. The “resident” definition covers the following persons:

- ▶ Any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof.
- ▶ Any person of a legal capacity including permanent resident such as sovereign funds owned by the Government or other entities exempted from public taxation or not subject to taxation in that State (for religious, charitable, educational, scientific or any other similar purpose).

The treaty should cover all UAE resident companies, including companies registered in the free zones that enjoy specific tax status derived from tax acts issued by the free zone authorities. The treaty does not contain any language that limits the scope of covered persons to UAE companies owned by Emirati citizens only, or to mainland-registered entities.

The place-of-effective-management criterion is adopted as a tie-breaker rule for determining the residence state for dual resident persons other than individuals.

Taxes covered (Article 3)

The treaty covers taxes on income and on capital in Saudi Arabia and the UAE. For Saudi Arabia, Zakat is expressly mentioned as covered by the treaty in addition to income tax, which makes it clear that Saudi entities subject to Zakat are covered by the tax treaty as Saudi residents. For the UAE, the treaty makes reference both to income and corporate taxes. There is currently no federal corporate income tax in the UAE and taxes are currently only imposed at the Emirate level on oil and gas producing companies and branches of foreign banks.

Permanent establishment (Article 5)

Article 5 of the treaty contains a definition of permanent establishment (PE), used to determine the threshold for taxation of business profits in the source state. It broadly follows the structure and content of the equivalent article in the UN MTC and adopts one of the MLI provisions that target the artificial avoidance of PEs:

- ▶ Article 5(3)(a) provides that a building site, a construction, assembly or installation project, or supervisory activities in connection therewith will constitute a PE only if such activities continue for a period of more than six months.
- ▶ A “service PE” provision in Article 5(3)(b) states that the furnishing of services, including consultancy services, through one or more employees or other personnel engaged by the enterprise for such purpose forms a PE if activities of that nature (for the enterprise itself or an associated project) continue within the Contracting State for a period or periods aggregating more than 183 days within any 12-month period.
- ▶ Article 5(5) includes an anti-fragmentation clause, also found in the MLI, whereby the exemption for auxiliary and preparatory activities will not apply to a fixed place of business used or maintained by an enterprise if the enterprise, or a connected enterprise, carries on business activities at that same place, or at another place in the same state, and (a) that place or other place constitutes a PE for the enterprise or the closely related enterprise; or (b) if the business activities constitute complementary functions that are part of a cohesive business operation and are not of a preparatory or auxiliary character.

- The dependent agent rule (Article 5(6)(b)) follows the UN MTC, meaning that an agent who has no authority to conclude contracts, but habitually maintains a stock of goods or merchandise from which such agent regularly delivers goods or merchandise on behalf of the enterprise, will be a PE if the agent is not of an independent status.

Taxation of business profits (Article 7)

Article 7 of the treaty follows the UN MTC and thus differs from the equivalent text of the OECD¹ MTC Article 7. In particular:

- The treaty incorporates a limited force-of-attraction rule that requires that the PE's profits include also profits from sales of goods or merchandise of the same or similar kind as those sold through the PE, as well as from other business activities carried on in that other state as those effected through that PE.
- As per Article 7(3), no tax deduction is allowed in the computation of the PE's taxable profits for any amounts paid to the Head Office or to any of its other offices (otherwise than towards reimbursement of actual expenses), by way of royalties, commissions, services fees or income under debt-claims (the latter limitation contains an exception for banking enterprises).
- Article 7(4) specifically notes that the business profits derived by an enterprise of a Contracting State from the export of merchandise to the other Contracting State shall not be taxed in that other Contracting State, while only profits from other activities carried on through a PE of the enterprise in the other State may be taxed therein.

An important implication from Article 7 for UAE businesses providing technical services and deriving other similar income from Saudi sources would be a full exemption from Saudi tax, provided such services or activities do not lead to the creation of a PE in Saudi Arabia.

Taxation of dividends, income from debt claims and royalties (Articles 10, 11, and 12)

Subject to specific anti-avoidance provisions, the following types of income cannot be taxed at source at rates higher than provided below:

- Dividends: 5%
- Income from debt-claims: 0%
- Royalties: 10%

Notably, the UAE does not impose any withholding taxes currently, while the Saudi withholding tax rate on dividends is 5%; on loan fees 5% and 15% on royalties.

Capital gains (Article 13)

Capital gains arising from the sale of unlisted companies' shares may be taxable in the source state regardless of the ownership threshold. Capital gains from disposal of listed stock are apparently exempt from tax in the source state, which is broadly in line with the Saudi domestic tax exemption.

Specific provisions (Article 27)

Article 27 provides for specific exemptions from tax for income from investments made by such persons as central banks, government authorities and public financial institutions wholly owned by the other state or its local government. Such exemption includes any gains derived from such investments, other than from immovable properties.

Miscellaneous provisions (Article 29)

The treaty references domestic tax anti-avoidance provisions that will prevail over the provisions of the tax treaty (Article 29(1)).

Furthermore, the treaty adopts the minimum standard under BEPS² Action 6, the Principle Purpose Test (PPT) with the aim to deny treaty benefits when considering all relevant facts and circumstances, obtaining that benefit is one of the principal purposes for entering into a particular transaction or arrangement.

Other tax treaty provisions

Article 25 of the treaty has a mutual agreement procedure (MAP) that includes an MLI-enhanced dispute resolution provision allowing the initiation of MAP in either of the Contracting States.

Article 26 includes a provision on the exchange of information between competent authorities of the Contracting States that is based on the UN MTC.

Effective date (Article 30)

The Contracting States shall notify each other in writing through diplomatic channels about the completion of all procedures required for the entry into force of the treaty. The treaty will enter into force on the first day of the second

month following the month in which the later of these notifications was received. If all procedures are completed by the end of 2019, the treaty will become effective as of 1 January 2020.

Implications

As this is the first bilateral treaty signed between two GCC Member States, the treaty is expected to further facilitate the mutual flow of trade and investments, as well as debt financing and further strengthen the economic ties between Saudi Arabia and the UAE. Businesses should review their operating structures in light of the new tax treaty. Both the Saudi Arabia and the UAE signed the MLI earlier in 2018. Based on Saudi Arabia's preliminary list of reservations and notifications (MLI positions) the treaty is already on the list of Covered Tax Agreements (CTAs). The UAE has not included the treaty on its preliminary list of CTAs, but is expected to include the treaty on its final list of CTAs. The new treaty applies the BEPS minimum standards under Actions 6 and 14.

An important development is the possibility to fully mitigate the Saudi domestic 5% WHT rate on income from debt-claims paid by Saudi resident companies to UAE resident lenders, provided the transaction is at arm's length and the recipient is the beneficial owner of such income. Careful considerations need to be placed to make sure that such exemption is obtained.

The PPT rule may affect the availability of the tax treaty protection relating to withholding tax on payments from a Saudi source like dividends, payments from debt claims and royalties. This means that in addition to the residency and beneficial ownership requirements, taxpayers would need to have business purpose and economic substance in the UAE. Furthermore, the adoption of the anti-fragmentation rule which may result in additional PE related risks, in particular for certain business arrangements involving procurement, logistics and distribution structures.

Endnotes

1. Organisation for Economic Co-operation and Development.
2. Base Erosion and Profit Shifting.

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

Ernst & Young Middle East, Dubai

- ▶ Rajan Parmar rajan.parmar@ae.ey.com
- ▶ Guy Taylor guy.taylor@ae.ey.com
- ▶ Chris Lord chris.lord@ae.ey.com
- ▶ Venice Segarra venice.segarra@ae.ey.com
- ▶ Ismael Hajjar ismael.hajjar@ae.ey.com
- ▶ Vera Averyanova vera.averyanova@ae.ey.com

Ernst & Young & Co (Public Accountants), Riyadh

- ▶ Asim Sheikh asim.sheikh@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
- ▶ 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
- ▶ Vladimir A. Gidirim vladimir.gidirim@sa.ey.com
- ▶ Yousef Eldaw yousef.eldaw@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
- ▶ Hatem Ghobara hatem.ghobara@sa.ey.com
- ▶ Javed Aziz Khan javed.aziz@sa.ey.com
- ▶ Jude deSequeira jude.desequeira@sa.ey.com

Ernst & Young & Co (Public Accountants), Jeddah

- ▶ Franz-Josef Epping franz-josef.epping@sa.ey.com
- ▶ Ayman Abu El Izz ayman.abueizz@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

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