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Proposed Income Tax Law

The Zakat Income Tax and Customs Authority of Saudi Arabia (ZATCA) has issued a draft of the proposed Income Tax Law (Proposed Law) for public consultations on 25 October 2023.

Proposed Income Tax Law The Zakat Income Tax and Customs Authority of Saudi Arabia (ZATCA)

Introduction

Essentially, the Proposed Law aims to widen the applicability of income tax on Residents and Non-Residents who enter into any business, investment, or property-related transactions. It also aims to bring the income tax regime in line with international best practices by removing ambiguities vis-à-vis taxable persons, taxable income, tax base, exemptions, deductions, etc. This short note highlights the major provisions under the Law.



Legal or Natural Resident

As the income tax applies to non-Saudi persons, the first and foremost issue relates to defining the Legal and Natural Resident and Non-Resident Persons. The Proposed Law distinguishes not only residents and non-residents but also defines in greater detail Legal Resident Persons (Legal Person) and Natural Resident Persons (Natural Persons).

Legal Resident Persons

Not only the entities duly incorporated in Saudi Arabia will be treated as Legal Persons, but the entities whose effective principal place of management is located in the Kingdom will also be treated as Legal Persons.

Natural Resident Person

Any person who is domiciled in Saudi Arabia; or holds a residence permit and resides in the Kingdom for (30) days continuous or aggregate during a period of 365 days; or any person (not having domicile or residence permit) who stays in the Kingdom for 183 days continuous or aggregate during a tax year; or stayed for a period of 90 days continuous or in aggregate in a year tax year beside staying for a total of 270 days continuous or aggregate during the last three tax years will all be considered as Natural Resident Persons.

Moving forward from the types of residents from legal or natural residents to taxable persons as a whole , and what is the definition of who will be treated as Taxable Persons.

Taxable Persons

After understanding the definition of Legal Person and Natural Person, let us delve now into the definition of who will be treated as Taxable Persons.

All Legal Persons having interest with respect to any interest or units held directly or indirectly by any non-Saudi person, or Legal Persons that conduct any activity related to natural gas investment or production of oil or hydrocarbons shall be considered taxable persons. At the same time, although the entities conducting their businesses or engaged in any activity through Permanent Establishments (PE) are considered as non-resident persons, they will be considered as taxable persons. Further, a non-resident person who does not have a permanent establishment, yet, derives an income from a source in Saudi Arabia and a non-resident natural person who conducts an activity in the Kingdom independently and regularly (opening of bank account in the Kingdom or trading or investing in stocks of the listed companies) will also be considered as taxable persons.



Sources of Income

Now let us see how the Proposed Law defines the source of income that will be treated as taxable. Revenues or Income generated from any activity or series of activities carried out to generate profit including commercial, investment, services, vocational industrial, agricultural, or any other similar activity including the use and exploitation of movable and immovable properties will be considered taxable income. The source of income also includes income derived from an Activity occurring in the Kingdom or which arises from a Permanent Establishment; or derived from dividends received from a Resident Legal Person or Director's Fee paid by a Resident Company or through the sale of shares, units or any type of partnership in a Resident Legal Person; or derived of movable properties in the Kingdom; or derived from exploitation of natural resources in the Kingdom or exploitation of industrial or intellectual properties in the Kingdom; or derived from professional or advisory services related to business provided to a Resident or Permanent Establishment or consideration paid by a Resident Company to its head office or related person.

Although, the income derived from the disposal, use or exploitation of any immovable property shall be considered as income generated from a source in the Kingdom, yet, in case of direct or indirect disposal of shares or units in a legal person, the total value related to immovable property be at least 50%. Similarly, capital gains generated directly or indirectly from the disposal of partnership, shares, interest, or units of a Non-Resident Legal Person shall be deemed not generated from a source in the Income in case 50% or more of their value is derived from the shares or units from assets not traded in the Kingdom at any time in the last one year. The Proposed Law has prescribed several conditions for treating activities related to income from debt claims, insurance and reinsurance premiums, etc.

Taxable Income

Besides the definition of taxable persons and sources of income, it is essential to understand what will be considered as 'Taxable Income' of Resident Legal Persons as well as Non-Resident Persons.

The Taxable Income is tied to 'total income' derived by Resident Legal Persons from Activities carried out in or **outside the Kingdom** regardless of the payment method. These include income arising from the ownership, trading, and disposal of interest or units in Legal Persons from dividends and other distributions; income from the exploitation of natural resources; management fee and director's fee; income from gifts, donations, contributions, or similar; undistributed profits in case of merger or demerger in which Non-Resident Legal Person is involved.



As regards a Non-Resident Legal Person that carries any activity through a Permanent Establishment (PE), besides the income derived from activities carried out through the PE, all of the income derived from a source outside the Kingdom to the extent it is connected with the PE shall be treated as taxable income.

Exempt from Tax

Income derived from the disposal of securities that are traded in the Saudi stock exchange or on a recognized foreign stock market if such stocks are also traded on a Saudi stock exchange will be exempt from tax. Besides, dividends, capital gains, and liquidation distributions resulting from direct ownership by a Resident Person of interest or units in Resident or Non-Resident Legal Person provided that the percentage of ownership or shareholding in the investee Legal Person is no less than 10%.



Tax Base

Tax Base is defined as the total income minus all of the deductible expenses and exempt income. Deductible Expenses include all normal expenses incurred for engaging in Activity as long as such expenses are not of a capital nature; expenses on R&D activities; depreciation; bad debts, gifts, and donations to licensed charitable organizations provided they do not exceed 10% of the annual net profit; contributions to a pension fund provided it is set up under a special regulation and such contribution is mentioned in the employment contract.

Payments to related persons; fines and penalties; expenses not connected with the Legal Person's activity, income tax payable in the Kingdom or any tax levied in other jurisdictions, royalties, proceeds or commission, amounts paid to headquarters outside the Kingdom, shall not be treated as deductible expenses.

The Proposed Law provides for the deduction of taxes paid by the Resident person on income generated outside the Kingdom from the total tax that is payable in Saudi Arabia as long as the related income is declared as part of the taxable income and provided that the deducted tax amount shall not be greater than the total tax due in the Kingdom for the profits realized outside the Kingdom.



Tax Rates

Unless otherwise provided, a flat rate of 20% shall be applied on the Tax Base of all Legal Persons and Natural Persons who carry out any Activity in the Kingdom; Non-Resident Persons who carry out any Activity in the Kingdom through Permanent Establishment; Non-Resident Persons (legal or natural) that derive capital gains income from a source in the Kingdom or persons that carry out natural gas investment activities.

The Tax rate for Tax Payers engaged in the production of oil and hydrocarbons shall range between 50% to 85% depending upon its total aggregate capital investment in the sector with the minimum total capital investment of SR.225 Billion attracting an 85% Tax rate and 50% Tax rate shall be applicable on entities that have total capital investment exceeding SR.375 Billion

Taxable Income of Resident Natural Person

An important aspect from the expatriate employees' perspective, the proposed Law provides that the income of Non-Saudi natural persons will be taxable only if it is related to that person's Activity carried out by him/her on an independent and regular basis; or income generated from an activity carried out or practised in or outside the Kingdom (if related to activity carried out on an independent and regular basis); income generated from movable or immovable assets; income generated from holding, trading and disposing of interest or units in Legal Persons and Dividends; income generated from gifts and donations etc.

The Proposed Law has clearly stated that compensation, such as wages, salaries, and the like received by natural persons against their works for another person shall not be considered income generated from an independent and regular Activity and shall not be considered taxable income; provided that the relationship is of employer-employee. Nor would there be any withholding tax on employees who work for Legal or Natural Persons. Additionally, bonuses received by members of the board shall be deemed as remuneration and hence not subject to any withholding tax.



Tax Withholding

All residents, whether or not they are taxpayers, and every PE in the Kingdom will be required to withhold tax from payments due to a non-resident person. While a 5% withholding tax shall be applied to dividends and rental payments, the tax rate will be 10% for the provision of services. The Royalty on any IP right, franchise fee; the tax rate shall be 15%.

Conclusion

Besides restating the current position vis-à-vis income tax and the regime for applying income tax on Non-Saudi nationals, the Proposed Law seeks to remove ambiguities regarding the treatment of taxable persons, taxable income, tax base, exemptions, deductions, tax rates for hydrocarbon activities.

While the Proposed Law has gone into detail defining transfer pricing, fair price, related persons, deductions, financial assets and financial leasing, depreciation, and liabilities, the Executive Regulations will provide further explanation.

