



## Saudi Arabian tax authorities introduce Virtual Service PE concept

### Executive summary

Saudi Arabia's Department of Zakat and Income Tax (DZIT) recently changed its approach to the interpretation of the permanent establishment (PE) concept with respect to services rendered by nonresidents in the Kingdom of Saudi Arabia (the Kingdom). DZIT has introduced the concept of a "Virtual Service PE," which may result in the denial of the withholding tax (WHT) relief claimed by nonresidents under the applicable double tax treaties of the Kingdom.

DZIT's new approach is not in line with the Kingdom's Income Tax Law (ITL) and the PE concept outlined in the double tax treaties concluded by the Kingdom, as well as the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN) Model Conventions. Nevertheless, it will likely affect most multinational enterprises which have concluded or plan to conclude service arrangements with customers in the Kingdom. Taxpayers should carefully consider the matter in advance, taking into account the wordings of tax indemnity clauses and other provisions of service agreements.

### Detailed discussion

DZIT has issued internal guidelines for processing requests for WHT exemptions and refunds made by nonresidents having no legal registration, and consequently having no PE, in the Kingdom. Although these guidelines are not publicly available, EY is aware that the new approach was expressed by DZIT in several response letters to requests for WHT reliefs under the applicable double tax treaties signed by the Kingdom.

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DZIT's guidelines provide a new interpretation of the Service PE concept, which takes into account only the duration of the contract itself, rather than the actual activities of the service provider in the Kingdom. In particular, DZIT introduces a "Virtual Service PE" concept, according to which a nonresident is deemed to have a PE in the Kingdom if the following conditions are met:

- ▶ A nonresident furnishes services to a person in connection with the latter's activity in the Kingdom
- ▶ The period during which such services are rendered according to the contract, exceeds the threshold period under the applicable tax treaty (most often the 183-day period threshold is used following the UN Model Convention)

DZIT's approach does not consider the physical presence of employees or contractors of a nonresident service provider for establishing the nexus to the source country, although such threshold condition is clearly provided by both the OECD and UN Model Conventions, and applied in many countries. Consequently, any work or services performed under cross-border agreements, which are concluded by a customer in the Kingdom with a nonresident for a period longer than the tax treaty threshold (e.g., 183 days) will, *prima facie*, create a Service PE in the Kingdom. This will be created even if employees of the former are not present there and perform their activities entirely offshore.

The new interpretation provided by DZIT is based on a few statements made by representatives of some developing countries during the 8th and 10th Session of the UN Committee of Experts for Tax Cooperation earlier in 2012 and 2014. According to the available public information on the hearings of the Committee, those representatives expressed a view that when applying the concept of a Service PE in Article 5 (3) (b) of the UN Model Convention, the "physical presence" test is not required to be fulfilled.

Such conclusion is the result of an unusual interpretation of Article 5 (3) (b) of the UN Model Convention, which uses a term "furnishing" with respect to services, and not the term "rendering" or "performing." In their view, "services furnished within the source country without the physical presence of personnel or employees in that country are covered by that provision if the furnishing of services within the country lasts more than 183 days or the threshold period in the applicable tax treaty".<sup>1</sup>

However, other representatives of the same committee of experts in both mentioned committee sessions did not support such viewpoint.

The majority of experts stated that such an interpretation would bring an unacceptable degree of uncertainty as to the proper meaning of the terms of the tax treaty and would frustrate their uniform understanding among the

states. They also agreed that states insisting on such an interpretation must make it clear in the text of the bilateral treaties being concluded.

In addition, the committee expressed an intention that the next update of the UN Model Commentary will reinstate the traditional understanding of Article 5 (3) (b) "Service PE," that the physical presence in the source state constitutes a prerequisite for creation of the PE in the source state. Finally, it is anticipated that the next update to the UN Model Commentary will also include the provision stating that no profits can be attributable to a PE as a result of activities performed outside of the PE state.

## Implications

The immediate implication of the foregoing is that, as a result of the issued guidelines, the applicability of tax treaty-based WHT exemptions or refunds with respect to cross-border services has become highly uncertain.

It is questionable whether the guidelines are in line with the legislation as currently enacted, and one may question whether they represent a type of "treaty override" through a unilateral interpretation of tax treaty terms. The majority of the double tax treaties of the Kingdom contain a so called Service PE provision: a PE is deemed to exist if a service provider furnishes services in a source state for a period or periods aggregating more than the threshold period under the applicable tax treaty.

Under the literal interpretation of the provision, the physical presence of the service provider in the Kingdom is required. However, under the new interpretation provided by DZIT, it is not necessary, effectively removing the required PE threshold for such-like projects.

Both foreign service providers and their customers in the Kingdom, who order services from nonresidents, should be prepared to face challenges when seeking advance exemption or filing refund applications from WHT on payments

for technical and consulting services payments to nonresidents in tax treaty situations.

Some of the local customers could be reasonably expected to be on a safer side and apply the domestic WHT rate when making payments to nonresidents for their work or services provided, leaving the latter to deal with tax refund vis-à-vis DZIT. This has become quite an onerous issue following the guidelines.

In practice and over time, several customary contractual legal remedies that could protect the

financial interests of foreign suppliers of services in case of foreign WHTs being applied by the local counterparty or government have been developed. These include tax indemnity (gross-up) clauses and other provisions. Such provisions become increasingly important in the context of mentioned changes.

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## Endnote

1. EY Note: or whichever is the threshold period in the applicable tax treaty.

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EYG No. CM5642

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