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Force of Attraction rule in the context of permanent establishment

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Introduction

01 This circular provides information and guidance about the Force of Attraction rule ("FOA") and its application in KSA according to the Income Tax Law (the "Law") and double tax avoidance agreements ("DTAT").

02 For the purposes of this circular, Permanent Establishment (PE) has the meaning assigned by Article 4 of the Law, and in DTATs to refer to a situation where a non-resident company is taxable in a country in which it should not normally be taxable unless it has a PE through which it conducts business. The income derived from this activity should generally be taxed only to the extent that it is 'attributable' to the PE.

Situational Context

01 The concept of FOA formally provided within the United Nations ("UN") – the Organization for Economic Co-operation and Development ("OECD") tax treaty models do not contain such provision – provides a framework for the determination of profits to be attributed to a PE and the potential disputes that may arise between two jurisdictions.

02 In the context of cross border transactions where a PE is triggered in a jurisdiction, it is important to consider the basis on which profits are attributed to the PE.

03 From a business and transfer pricing perspective, profit allocation methods are specifically defined and often provided within the domestic laws to respond to the globalization of the economy and the increasing volume of cross-border intercompany transactions and the associated challenges.

04 This circular deals with the application of FOA in the following contexts:

- FOA application under the Law in KSA in the absence of a DTAT between KSA and the country of residence of the PE's head quarters.
- FOA application in the context of DTAT between KSA and the country of residence of the head quarter of the PE:
  - DTAT including FOA rule provision
  - DTAT nullifying the application of the FOA

Scope of Application

01 The scope of the attributable income may extend, in particular cases, through the application of the FOA rule. The FOA rule may apply to particular situations and extend the scope of the taxable income in the country in which a PE is deemed to exist. Accordingly, not only the income from activities or assets is taxed where the PE is located but also income derived by its foreign head office from the activities or assets in the country where the PE is located.

02 The FOA rule can be partial or global in its application to the income that is attributable to a PE and accordingly taxable.

03 Under partial application of the FOA, only income that is facilitated by the PE for similar activities or for sales directly realized by the nonresident could effectively be attributable to the PE and taxed in the country in which the PE is deemed to exist.

04 The application of the FOA rule globally would result in the attribution and taxation of the entire income derived by the nonresident for whom the PE exists in the country of the PE, irrespective of whether the income is directly related or facilitated by the PE.

Figure 1 depicts these concepts.

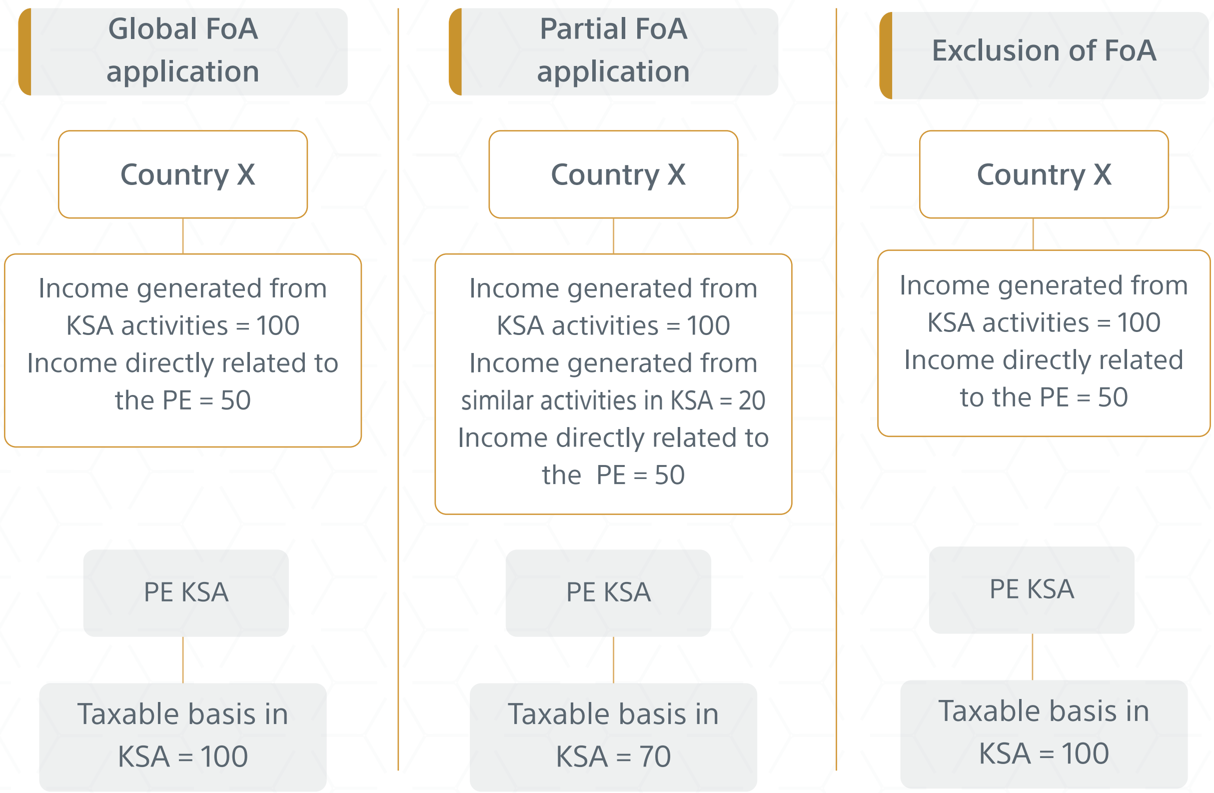

Figure 1: Partial / Global FOA rule

FOA: Absence of a Tax Agreement with KSA

01 Paragraph 10 of Article 5 of the Law provides that income attributable to a PE of a non-resident located in KSA should include income from sales in the Kingdom of goods of the same or similar kind as those sold through such a PE, and income from rendering services or carrying out another activity in the Kingdom of the same or similar nature as an activity performed by a non-resident through a PE.

02 The domestic provision refers to the concept of a partial application of FOA, detailed further in the following section, whereby the income derived by a nonresident company having a PE in KSA would be brought into the scope of KSA taxation regardless of whether the income is directly attributed to the PE or facilitated by the PE. However, the condition of similarity of activity exists to restrict the FOA application only to a specific category of income.

03 Example 1 illustrates the attribution of income in the context of a PE in KSA:

Example 1:

A branch of an American bank is operating in KSA through a branch. The branch headquarter in the USA has a contract with a KSA third party company to provide funding services in respect of the company's project in KSA and overseas.

The income derived from the banking activity performed in KSA by the foreign bank PE– i.e. borrowing and lending funds to third parties – is directly attributable to the PE and therefore brought within the scope of corporate tax in KSA.

It is also attributed to the PE in KSA, the income generated by the headquarter in respect of the funding contract with the Saudi third party company, on the basis that the activity performed by the USA headquarter is similar to the one from which the PE is deriving its income.

FOA: Presence of a Tax Agreement with KSA

01 The Kingdom has signed more than 52 DTAT with their specificities and variants, however from a perspective of the application of the FOA rule, two categories of DTAT can be distinguished:

- DTAT that includes a FOA provisions; and
- DTAT that does not include the concept of FOA

Tax Agreement including FOA provision

02 There are 14 DTAT[1] with the KSA including the FOA provision[2], none of these DTAT is seeking the “global application” of the FOA rule but rather a partial application of such rule.

03 In general, those DTATs follow the generic provision of the UN treaty model stating a condition of similarity of activity or sale to allow the allocation of income even if not directly derived by the PE. Therefore, in principle, a company incorporated in a jurisdiction containing a FOA provision under its DTAT with the

(1) Countries which have a DTAT with KSA that contains FoA are Azerbaijan, Bangladesh, Ethiopia, Georgia, Jordan, Kazakhstan, Mexico, Macedonia, Tunisia, Ukraine, United Arab Emirates, Uzbekistan, Venezuela and Vietnam.

(2) A list is provided in Appendix to this Circular. This list is applicable as of the day of issuance of this Circular and is therefore subject to change.

KSA, and deemed to have created a PE in the KSA, should see the following types of income be brought within the tax scope in the KSA:

- the profits directly attributable to the PE;
- sales in the KSA of goods or merchandise of the same or similar kind as those sold through the PE; or
- other business activities carried on in KSA of the same or similar kind as those effected through the PE.

04 Examples 2 and 3 illustrate the application of the partial FOA rule under the existing treaties:

Example 2:

A company based in the United Arab Emirates is providing maintenance services in KSA via its employees physically based locally for an extensive period. Based on the DTAT between the UAE and KSA, the company is deemed to have a PE in KSA due to this specific activity.
The income derived from the service activity is directly attributable to the PE and therefore brought within the scope of corporate tax in KSA.
In addition to the maintenance services provided on specific equipment, the company is providing similar services on a remote manner and in relation to other equipment that is located in KSA. Although this activity alone may not trigger a PE in KSA as there is no direct relation to services performed under the PE, the income derived from it should still be brought within the scope of corporate tax in KSA based on the application of the FoA rule as per the DTAT.

Example 3:

A branch of a Vietnamese bank is operating in KSA through a PE. The income derived from the banking activity performed in KSA – i.e. borrowing and lending funds to third parties – is directly attributable to the PE and therefore brought within the scope of corporate tax in KSA.
Income or profits derived from loans of the head quarter to Saudi company, generally, are not regarded as part of income of the branch of the bank situated in the kingdom unless they are effectively connected to the this branch. However, based on the provision of the DTAT with Vietnam and the application of partial FoA rule, income derived from funding transaction should be attributed to the main activity of the PE and taxed accordingly in KSA.
It should however be noted that such income paid to the head office or any other group offices shall not be allowed for deduction for the purpose of determining the taxable profit of the PE.

Tax Agreement nullifying the application of the FOA provision

05 Conversely, there are 38 DTAT[3] that were signed and do not include the FOA provision[4]. The exact wording of the FOA provision in the DTAT's may differ.

(3) Countries which have a DTAT with KSA that do not include the FoA are: Albania, Algeria, Austria, Belarus, Bulgaria, China, Cyprus, Czech, Egypt, France, Greece, Hong Kong, Hungary, India, Ireland, Italy, Japan, Korea, Kosovo, Kyrgyzstan, Luxembourg, Malaysia, Malta, Netherlands, Pakistan, Poland, Portugal, Romania, Russia, Singapore, South Africa, Spain, Sweden, Syria, Tajikistan, Turkey, Turkmenistan, United Kingdom of Great Britain and Northern Ireland

(4) A list is provided in Appendix to this Circular. This list is applicable as of the day of issuance of this Circular and is therefore subject to change.

06 Under those DTAT, only the profits directly attributable to the PE may be taxed in KSA. Profits directly attributable to the PE encompasses the income derived from the sole activity of the PE in KSA.

07 Example 4 illustrates the application of this clause:

Example 4:

A company based in Japan is supplying material in KSA for the purpose of a construction project for which the company also provides on-site installation/ maintenance and project management services for the duration of the project (which is expected to exceed a year). Based on the DTAT between Japan and KSA, the company is deemed to have a PE in KSA due to the installation/maintenance and service activity performed locally. In addition, the company provide maintenance services in Japan for equipment belong to another Saudi company.

The income derived from the service activity is directly attributable to the PE and therefore brought within the scope of corporate tax in KSA, however, due to the provisions of the DTAT nullifying the application of the FoA, the income derived from the mere sale of material and the income from the maintenance of the equipment in Japan should not fall within the scope of tax in KSA.

Appendix

Country/ DTAT Partner	FOA rule	Application	Model
Albania	None	KSA allowed to tax profits attributable to the PE - of the business in Albania - that is situated in KSA.	OECD
Algeria	None	KSA allowed to tax profits attributable to the PE - of the business in Algeria - that is situated in KSA.	OECD
Austria	None	KSA allowed to tax profits attributable to the PE - of the business in Austria - that is situated in KSA.	OECD
Azerbaijan	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Azerbaijan to the extent that they meet conditions (b) and (c).	UN
Bangladesh	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Bangladesh to the extent that they meet conditions (b) and (c).	UN
Belarus	None	KSA allowed to tax profits attributable to the PE - of the business in Belarus - that is situated in KSA.	OECD

Bulgaria	None	KSA allowed to tax profits attributable to the PE - of the business in Bulgaria - that is situated in KSA.	OECD
China	None	KSA allowed to tax profits attributable to the PE - of the business in China - that is situated in KSA.	OECD
Cyprus	None	KSA allowed to tax profits attributable to the PE - of the business in Cyprus - that is situated in KSA.	OECD
Czech	None	KSA allowed to tax profits attributable to the PE - of the business in Czech - that is situated in KSA.	OECD
Egypt	None	KSA allowed to tax profits attributable to the PE - of the business in Egypt - that is situated in KSA.	OECD
Ethiopia	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Ethiopia to the extent that they meet conditions (b) and (c).	UN
France	None	KSA allowed to tax profits attributable to the PE - of the business in France - that is situated in KSA.	UN

Georgia	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Georgia to the extent that they meet conditions (b) and (c).	UN
Greece	None	KSA allowed to tax profits attributable to the PE - of the business in Greece - that is situated in KSA.	OECD
Hong Kong	None	KSA allowed to tax profits attributable to the PE - of the business in Hong Kong - that is situated in KSA.	OECD
Hungary	None	KSA allowed to tax profits attributable to the PE - of the business in Hungary - that is situated in KSA.	OECD
India	None	KSA allowed to tax profits attributable to the PE - of the business in India - that is situated in KSA.	OECD
Ireland	None	KSA allowed to tax profits attributable to the PE - of the business in Ireland - that is situated in KSA.	OECD
Italy	None	KSA allowed to tax profits attributable to the PE - of the business in Italy - that is situated in KSA.	OECD

Japan	None	KSA allowed to tax profits attributable to the PE - of the business in Japan - that is situated in KSA.	OECD
Jordan	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Jordan to the extent that they meet conditions (b) and (c).	UN
Kazakhstan	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Kazakhstan to the extent that they meet conditions (b) and (c).	UN
Korea	None	KSA allowed to tax profits attributable to the PE - of the business in Korea - that is situated in KSA.	OECD
Kosovo	None	KSA allowed to tax profits attributable to the PE - of the business in Kosovo - that is situated in KSA.	OECD
Kyrgyzstan	None	KSA allowed to tax profits attributable to the PE - of the business in Kyrgyzstan - that is situated in KSA.	OECD
Luxembourg	None	KSA allowed to tax profits attributable to the PE - of the business in Luxembourg - that is situated in KSA.	OECD

Malaysia	None	KSA allowed to tax profits attributable to the PE - of the business in Malaysia - that is situated in KSA.	OECD
Malta	None	KSA allowed to tax profits attributable to the PE - of the business in Malta - that is situated in KSA.	OECD
Mexico	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Mexico to the extent that they meet conditions (b) and (c).	UN
Netherlands	None	KSA allowed to tax profits attributable to the PE - of the business in the Netherlands - that is situated in KSA.	OECD
Pakistan	None	KSA allowed to tax profits attributable to the PE - of the business in Pakistan - that is situated in KSA.	OECD
Poland	None	KSA allowed to tax profits attributable to the PE - of the business in Poland - that is situated in KSA.	OECD
Portugal	None	KSA allowed to tax profits attributable to the PE - of the business in Portugal - that is situated in KSA.	OECD

Macedonia	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Macedonia to the extent that they meet conditions (b) and (c).	UN
Romania	None	KSA allowed to tax profits attributable to the PE - of the business in Romania - that is situated in KSA.	OECD
Russia	None	KSA allowed to tax profits attributable to the PE - of the business in Russia - that is situated in KSA.	OECD
Singapore	None	KSA allowed to tax profits attributable to the PE - of the business in Singapore - that is situated in KSA.	OECD
South Africa	None	KSA allowed to tax profits attributable to the PE - of the business in South Africa - that is situated in KSA.	OECD
Spain	None	KSA allowed to tax profits attributable to the PE - of the business in Spain - that is situated in KSA.	OECD
Sweden	None	KSA allowed to tax profits attributable to the PE - of the business in Sweden - that is situated in KSA.	OECD

Syria	None	KSA allowed to tax profits attributable to the PE - of the business in Syria - that is situated in KSA.	OECD
Tajikistan	None	KSA allowed to tax profits attributable to the PE - of the business in Tajikistan - that is situated in KSA.	OECD
Tunisia	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Tunisia to the extent that they meet conditions (b) and (c).	UN
Turkey	None	KSA allowed to tax profits attributable to the PE - of the business in Turkey - that is situated in KSA.	OECD
Turkmenistan	None	KSA allowed to tax profits attributable to the PE - of the business in Turkmenistan - that is situated in KSA.	OECD
Ukraine	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Ukraine to the extent that they meet conditions (b) and (c).	UN
United Arab Emirates	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in the United Arab Emirates to the extent that they meet conditions (b) and (c).	UN

United Kingdom of Great Britain and Northern Ireland	None	KSA allowed to tax profits attributable to the PE - of the business in the UK - that is situated in KSA.	OECD
Uzbekistan	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Uzbekistan to the extent that they meet conditions (b) and (c).	UN
Venezuela	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Venezuela to the extent that they meet conditions (b) and (c).	UN
Vietnam	Limited	KSA allowed to tax profits attributable to the PE in KSA, as well as other profits of the business that are derived in Vietnam to the extent that they meet conditions (b) and (c).	UN

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