

## **Research Note: Analysis of the Application of Income Tax Law to Income Generated Overseas by Capital Companies Located in the Kingdom of Saudi Arabia**

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### **ABSTRACT**

This study analyzed the scope of imposing income taxes on the income generated from the local and foreign operations of capital companies located in the Kingdom of Saudi Arabia (KSA) and the challenges accompanying the new amendment to the tax laws and their possible improvements. The amendment in the executive regulation of the income tax law stipulates that the resident money company is subject to the tax on its income inside and outside the Kingdom, but it is silent about individuals, which may create challenges. By conducting a comparative analysis of the tax laws of KSA and the United States of America, the study proposed suggestions through which the KSA can develop a more robust legal environment in the field of taxation pertaining to income tax law.

Keywords: Saudi tax law; foreign income; resident companies in the Kingdom of Saudi Arabia; Internal Revenue Code

### **1. INTRODUCTION**

Unlike the income tax law of the United States of America, Saudi tax law fundamentally emphasizes the principle of territoriality in the imposition of income tax. However, an article on the executive regulation of income tax as amended following the Ministerial Resolutions No. 3294, dated 11/15/1431 AH (Oct 10, 2010) and No. 1727, dated 25/5/1439 AH (Feb 10, 2018), stipulated that the income generated by a capital company located in the Kingdom of Saudi Arabia (KSA) through its operations and those of its branches, within or outside the Kingdom, is subject to Saudi income tax law. As there is a paucity of research on this topic from the Saudi tax law perspective, this analysis contributes to law and business research in the legal literature by comparing existing Saudi tax laws with foreign legal systems to facilitate further studies in this field. Hence, this study ascertains the scope of imposing income taxes on the income generated from local and foreign operations of capital companies located in the Kingdom and the challenges accompanying the new amendment and possible improvements to this tax law. It proposes recommendations through which the KSA can develop a more robust legal environment in the field of taxation pertaining to income tax law.

### **2. MATERIALS AND METHODS**

To conduct a comparative analysis of the tax laws of KSA and the United States of America, the extent to which the income generated by a capital company located in KSA reflects its operations overseas was analyzed. The relevant statutory texts were extrapolated from the income tax law issued by the Royal Decree No. M/1 on 15/1/1425, corresponding to 06/03/2004 AD, regulations on income tax issued by the Ministry of

Finance, and the United States tax law. By extrapolating from these relevant statutory texts on income tax law, this study presents the challenges surrounding the extent to which the income generated by a capital company located in the Kingdom is subject to its operations overseas, thereby providing recommendations for mitigating such challenges.

### 3. SOURCES OF INCOME, AS RECOGNIZED BY THE SAUDI TAX LAW

Apart from income tax laws, taxation constitutes a relatively new element in the economic system of the KSA.<sup>1,2</sup> In addition to income tax, the KSA has advanced toward imposing different types of taxes on commodities, goods, and services, as well as value-added tax (VAT)<sup>3</sup> and a selective commodity tax.<sup>4</sup> However, this study primarily focuses on income tax. The Saudi income tax law is based on the imposition of tax on any income that is generated from an activity that was executed in the KSA.<sup>5</sup> For example, Article 5 of the Saudi income tax law states the following:

*“(a) In KSA, income is considered accrued in any of the following cases:*

*(1) If it is derived from an activity that took place in KSA.*

*(2) If it is derived from immovable properties, including proceeds from the disposal of a share of such immovable properties, as well as from the disposals of shares, stocks, or partnerships in a company property, which mainly consist (directly or indirectly) of shares in immovable properties in KSA.*

<sup>1</sup>For more information, refer to Altawyan (2020).

<sup>2</sup>The current income tax law was issued on 15/1/1425, corresponding to 06/03/2004 AD by Royal Decree No. M/1.

<sup>3</sup>In June 2016, the GCC states consented to the signing of a VAT Agreement to impose VAT across all GCC states. In February 2017 (Jumada Al-Awwal 1438), the KSA ratified the GCC VAT Agreement and committed to imposing VAT from January 1, 2018. For further details on the VAT Law, refer to <https://zatca.gov.sa/en/eServices/Pages/default.aspx?taxtype=3>. Accessed on May 20, 2022.

<sup>4</sup>Application of excise tax in the KSA shall follow the GCC Unilateral Agreement for Excise Tax; see the ZATCA Official website for more information:

<https://zatca.gov.sa/en/eServices/Pages/default.aspx?taxtype=4>

<sup>5</sup>For information on how various jurisdictions determine the residency status for taxation, see Ault and Arnold (2004) and VanDenburgh (2012). Article 2 of the Saudi Income Tax Law explains that Persons Subject to Taxation are determined as follows: *“(a) A resident capital company with respect to shares of the non-Saudi partners. (b) A resident non-Saudi natural person who conducts business in the Kingdom. (c) A nonresident who conducts business in the Kingdom through a permanent establishment. (d) A nonresident with other taxable income from sources within the Kingdom. (e) A person engaged in the field of natural gas investment. (f) A person engaged in the field of oil and hydrocarbons production.”* For more information on Saudi tax law, see Dr. Mahmoud Muhammad Al-Demerdash, *Zakat and Taxes in the Light of the Provisions of the Zakat Collection and Income Tax Regulations in the Kingdom of Saudi Arabia* (1st ed 2019) 187, 207, Saad Muhammad Al-Huwaimel, ‘Tax Accounting and Zakat in the Kingdom of Saudi Arabia’ (2013) 63, 64, and Mufleh Rabi’ an Al-Qahtani and Abdul-Sattar Abdul Hamid Salmi, *Al-Wajeez fi: Explaining the Provisions of Zakat and Tax Legislations* (1st ed 2018) 17–41. Mahmoud Atef Al-Banna, *The Zakat and Tax System in the Kingdom of Saudi Arabia* (1983, Dar Al Uloom for Printing and Publishing, Riyadh) 249–275. For more information on Saudi income tax provisions for commercial companies, see Dr. Khalid Abdulaziz Al-Rowais, *Commercial Companies, according to the Saudi Companies Law and Judicial Applications* (1st ed, Al-Shukri 2019).

(3) *If it is derived from the disposal of shares or a partnership in a resident company.*

(4) *If it is derived from the lease of movable properties utilized in KSA.*

(5) *If it is derived from the sale or license for use of industrial or intellectual properties employed in KSA.*

(6) *If it is derived from dividends, the management or directors' fees that are paid by a resident company.*

(7) *If it is derived from amounts paid for services rendered by a resident company to the company's headquarter or to an affiliated company.*

(8) *If it is derived from amounts paid by a resident company for services rendered in whole or in part in KSA.*

(9) *If it is derived from amounts paid for the exploitation of a natural resource in KSA.*

(10) *If the income is attributable to a permanent establishment of a nonresident located in the Kingdom, including income from the sales of goods that are the same or similar to those sold through such a permanent establishment and income from rendering services or conducting another activity that is the same or similar to those performed by nonresidents through a permanent establishment in KSA.*

(b) *The place where the income was generated shall not be considered when determining its source.*

(c) *For this article, a payment made by a permanent establishment of a nonresident in KSA is considered paid by a resident company."*

Although the principle of territoriality with regard to income taxation is explicit in the Saudi income tax law, an article in the executive regulation of income tax, as amended, following Ministerial Resolutions No. 3294, dated 11/15/1431 AH (Oct 10, 2010) and No. 1727, dated 25/5/1439 AH (Feb 10, 2018), stipulated that the income generated by the capital company located in the KSA from its operations and those of its branches within or outside the KSA is subject to the income tax system. The executive regulations mentioned the capital company and did not specify individual status for its income worldwide.

A major challenge here is the imposition of such an order through an executive regulation and not through the legislative authority. The author considers the imposition of income tax on operations conducted outside the KSA as an objective rule and requirement that should be imposed on taxpayers through laws and legislative authorities, rather than through circulars and executive regulations. For example, in the United States law, individuals and corporations are subject to taxes on worldwide income under the Internal Revenue Code, IRC, if the meaning of residence applies according to the American law. According to Mindy Herzfeld, *"The United States is unusual among nations in taxing its citizens on their worldwide income. A U.S. corporation taxable on its worldwide income*

is a corporation created or organized in the United States. I.R.C. § 7701 (a)(3) and (4)”<sup>6</sup>. The Internal Revenue Code (IRC) that governs and regulates the resident individual and corporation in the USA for taxing their worldwide income is “*the domestic portion of federal statutory tax law in the United States and is under Title 26 of the United States Code (USC). The IRC has 11 subtitles, including income taxes, employment taxes, coal industry health benefits, and group health plan requirements. The implementing agency of IRC is the Internal Revenue Service (IRS).*”<sup>7</sup> A federal tax law, which begins with IRC and is enacted by Congress is a legislative authority in the USA in Title 26 of the United States Code (26 USC).<sup>8</sup> Also, in the case of *Cook v. Tait* - 265 U.S. 47, 44 S. Ct. 444 (1924), the issue arises if the Congress has the power to tax the income received by a native citizen of the United States domiciled abroad with property situated abroad. In this case, the Court rejected the taxpayer’s contention that the United States could only impose a tax when the person was generating income within the territorial limits of the United States and found that the imposition of tax on income derived a foreign country is considered legal. As with the American law, such provisions, which have a significant impact on taxpayers, must be imposed through the legislative authority as a law and not through regulations. It is unclear how the Saudi tax judiciary dealt with this issue, as the study did not find a case on this matter.

The author does not discuss the issue regarding the principal of the imposition of tax on that income; however, by the same token, the author reviewed the method of imposing taxes on worldwide income. The author’s contention is that it should have been enforced by law rather than circulars and executive regulations. Hence, this study proposes the enforcement of this principle through the introduction of a law that supports the commission’s procedure; such a law should be submitted to the legislative authority of the KSA for promulgation to avoid the possible confusion involved in its implementation through executive regulations. Accordingly, the legal environment will be reinforced when the KSA support such procedures through the law, and this should, in turn, increase confidence in the tax authority’s procedures regarding the collection of income taxes. Moreover, the proposal might stabilize the judicial rulings and clarify judicial principles regarding these taxes, unlike the procedures of the current body, which are based on executive regulations without legislation.

To determine whether the ministry has a right to underpin its subjective rules, Article 67 of the Saudi Basic Law of Governance (equivalent to the constitution in other countries), issued by Royal Order No. A/90, 27 Sha’ban 1412H, 1 March 1992, stipulates the following:

*The regulatory authority shall be responsible for the [creation] of legislation and regulations [that] will safeguard all interests and remove evil from the state’s affairs, according to [Sharī’ah]. Its powers shall be exercised according to*

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<sup>6</sup>International Taxation in a Nutshell,

Mindy Herzfeld, West Academic Publishing; 11th edition (August 30, 2018), pg 25 and 28. See also see also, International Tax Primer 4th Edition, Kluwer Law International; 4th edition (January 14, 2019), Brian J. Arnold, pg 58. Also see, U.S. Code § 871, 7701(b), (a) and (4).

<sup>7</sup>See Legal Information Institute,

Cornell Law School website at [https://www.law.cornell.edu/wex/internal\\_revenue\\_code\\_\(irc\)](https://www.law.cornell.edu/wex/internal_revenue_code_(irc)). accessed on July 13, 2022. See also, See IRS official website: <https://www.irs.gov/privacy-disclosure/tax-code-regulations-and-official-guidance>.

<sup>8</sup>See IRS official website: <https://www.irs.gov/privacy-disclosure/tax-code-regulations-and-official-guidance>.

*provisions of this law, the Law of the Council of Ministers, and that of the Shura Council.*

Hence, according to the provisions of the Basic Law, the King, as the Head of State, and the Council of Ministers, as the principal legislative authority, have the power to regulate internal affairs and regulations by enacting or amending any Saudi law and the authority to accept or reject proposals from either of the two legislative bodies (The Council of Ministers Law, Art. 20, 1993; The Shura Council Law, Arts. 17, 18, 1992). Foreign legal affairs, international treaties, agreements, regulations, and concessions are approved or modified by royal decrees after they have been reviewed by the legislative authorities (The Council of Ministers Law, Art. 20, 1993; The Shura Council Law, Arts. 17, 18, 1992). In summary, the King, the Council of Ministers, and the Shura Council constitute the legislative authority of the State.

In addition, each minister has the authority to submit and propose a bill or regulation relating to matters of the ministry but not to establish a law. For example, Cabinet Resolution No. 126 (2016 [1436 AH]) stipulated that the Minister of Finance would issue the necessary decisions to implement Royal Decree No. M/40, which established the *zakāt* collection system. It means that a minister reserves the authority to issue executive decisions and circulars but not legislative authority.

Another matter is that it might facilitate the identification of tax fraud as companies operating in the KSA may conduct their foreign activities through individual accounts to evade tax as no tax is imposed on the financial activities of individuals outside the KSA. Owing to the lack of case precedents on this subject and the recency of these amendments, it is difficult to determine the extent of the void caused by such an amendment in the executive regulations. However, in imposing taxes on individuals and companies on foreign activities, the American-type system certainly lessens the possibility of any tax evasion by local companies, which the Saudi legislature must consider.

#### 4. CONCLUSION

This study analyzed the extent to which the income generated by individuals and companies located in the KSA reflects their operations outside the Kingdom. The amendment in the executive regulation of the income tax system stipulates that the resident money company is subject to the tax on its income inside and outside the Kingdom, but it is silent about individuals, which may create challenges. Companies may conduct their foreign activities through individual accounts to evade tax, which may also weaken the expansion of foreign investments within Saudi entities. The Zakat, Tax and Customs Authority (ZATCA) of the KSA must strive to safeguard public money and the money collected from businesses and individuals in general. Fraudulent attempts to reduce taxable income must also be prevented. However, this feat must be achieved through legislation and the issuance of laws in accordance with the procedures stipulated in the Saudi Basic Law. The author contends that tax changes must be circumscribed by law and not by the executive rules issued through ministerial regulations, circulars, or decisions by the ministers.

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