

## Introduction:

The Professional Magazine is a periodical publication issued by Ali Ibrahim Al Nasser & Partners, Certified Public Accountants and Consultants. In this twenty-sixth issue, we discuss the provisions relating to Permanent Establishments. We also review a number of common professional mistakes and practices, including the failure to verify loan interests and the extent to which they are deductible when preparing the Income Tax base.

# Key Updates and Developments

## 1- The Auditing Standards Board in the Authority Approves the Revised International Standard on Auditing (ISA) 240

The International Auditing and Assurance Standards Board (IAASB) has issued the revised International Standard on Auditing (ISA) 240, which addresses the auditor's responsibilities relating to fraud in an audit of financial statements.

The updates to ISA 240 include additional clarifications of the requirements, expanded guidance and application material, and enhanced linkage with other International Standards on Auditing to assist auditors in obtaining a better understanding of their role and responsibilities relating to fraud in the audit of financial statements. A key advancement in the revised standard is the clearer articulation of the auditor's role and responsibilities regarding fraud, the enhancement of audit procedures for identifying and assessing risks of material misstatement due to fraud while considering the requirements of other relevant standards, and the strengthening of the auditor's exercise of professional skepticism. The revised standard also reduces references to a neutral mindset when assessing risks and evaluating audit evidence. Furthermore, it enhances transparency by improving and clarifying requirements relating to communications with management, those charged with governance, and reporting to authorities outside the entity in accordance with applicable laws and regulations. It also promotes greater transparency in the auditor's report regarding audit procedures performed in relation to fraud.

## 2- The Authority Adopts Updates to International Auditing and Assurance Standards Relating to the Use of the Work of an External Expert

The International Auditing and Assurance Standards Board (IAASB) has issued limited amendments to its standards to maintain consistency between the requirements of those standards and the updates made by the International Ethics Standards Board for Accountants (IESBA) to the International Code of Ethics for Professional Accountants regarding the use of the work of an external expert.

The amendments, which were made primarily to International Standard on Auditing (ISA) 620, International Standard on Review Engagements (ISRE) 2400, International Standard on Assurance Engagements (ISAE) 3000, and International Standard on Related Services (ISRS) 4400, are intended to strengthen consistency between the requirements of these standards relating to the use of the work of an external expert and the relevant ethical requirements, particularly those contained in the International Code of Ethics for Professional Accountants, including the recent updates concerning the use of external experts. In substance, the amendments are enhancement-focused and are intended to assist professional accountants in fulfilling their professional and ethical responsibilities when using the work of an external expert, whether in the context of audit engagements, reviews of financial statements, assurance engagements other than audits or reviews of financial statements, or related services engagements (agreed-upon procedures engagements).

# Permanent Establishment Provisions in Income Tax

A permanent establishment of a non-resident is considered one of the important tax concepts with significant practical implications in tax practice. The importance of a permanent establishment arises where a non-resident person has a permanent establishment in the Kingdom through which it conducts its activities. In such cases, the non-resident becomes subject to Income Tax in the Kingdom only in respect of the activities carried out through the permanent establishment. Article (4) of the Income Tax Law defines a permanent establishment as a fixed place of business through which the business of a non-resident is wholly or partly carried on, including activities conducted through an agent.

Accordingly, the concept of a permanent establishment is linked to non-resident persons in the Kingdom who do not meet the residency criteria but conduct business activities in the Kingdom through a permanent establishment. As a result of conducting business through a permanent establishment, a number of tax implications and provisions arise, the most notable of which is that the non-resident becomes subject to Income Tax in respect of the activities of the permanent establishment.

Accordingly, it is important to understand the cases and forms in which a permanent establishment of a non-resident is deemed to exist, in addition to the resulting tax implications and provisions.

As a general rule, a person who does not meet the residency requirements in the Kingdom is not subject to Income Tax therein unless one of the following two situations applies:

First: Where a non-resident carries on business in the Kingdom through a permanent establishment, the non-resident is subject to Income Tax only on the activities of that permanent establishment.

Second: Where a non-resident derives income from a source in the Kingdom without having a permanent establishment therein, such income is subject to withholding tax provisions.

Accordingly, the main effect of having a permanent establishment for a non-resident in the Kingdom is that the non-resident becomes subject to Income Tax on the activities of that permanent establishment, where the concept of a permanent establishment applies to the place through which the business is carried out in the Kingdom. Consequently, the non-resident in this case will not be subject to withholding tax on the income derived, but will instead be subject to Income Tax on the activities of the permanent establishment. The taxable base for the non-resident carrying on business in the Kingdom through a permanent establishment is the taxable income generated from that establishment or income connected to it, after deducting allowable expenses in accordance with the provisions of the Law and its Implementing Regulations. However, profits transferred from the permanent establishment to the non-resident head office will be subject to withholding tax as they are treated as dividend distributions under the applicable withholding tax provisions.

The existence of a permanent establishment of a non-resident in the Kingdom also affects the application of double taxation relief mechanisms, as double taxation agreements in many cases give priority to the taxing rights of the state in which the permanent establishment is located. In most situations, that state is entitled to tax the income generated, rather than the country of residence of the person carrying on the activity through a permanent establishment in the other state.

Accordingly, the key tax implications of having a permanent establishment can be summarized as follows:

- The non-resident is subject to Income Tax on income derived from the permanent establishment's activities.
- The non-resident is not subject to withholding tax on income derived from a source in the Kingdom.
- The application of double taxation treaty provisions is affected.
- Distributions of profits from the permanent establishment to the head office are subject to withholding tax.

Regarding the concept of a permanent establishment and the cases in which it is deemed to exist, Article (4) of the Income Tax Law defines a permanent establishment as a fixed place of business through which the business of a non-resident is wholly or partly carried on, including activities conducted through an agent.

The Article also sets out examples of cases that are considered permanent establishments under this definition, as follows:

1. Construction sites, assembly facilities, and related supervisory activities, which may include contracting project sites under the supervision of a non-resident person.
2. Installations and sites used for surveying natural resources, drilling equipment, vessels used in natural resource exploration, and related supervisory activities.
3. A fixed base through which a non-resident natural person carries on business, which may include offices, workshops, and factories through which the non-resident conducts activities in the Kingdom.
4. A branch of a non-resident company authorized to conduct business in the Kingdom, which is the most common form and includes branches of foreign companies established outside the Kingdom, as such branches are considered a permanent establishment for tax purposes.

The agent may also fall within the concept of a permanent establishment of a non-resident where the agent is a dependent agent who is granted any of the powers specified in Article (4) of the Implementing Regulations, as follows:

- Negotiating on behalf of the non-resident.
- Concluding contracts on behalf of the non-resident.
- Holding a stock of goods in the Kingdom owned by the non-resident, from which it regularly fulfils customer orders on behalf of the non-resident.
- The place where the non-resident carries on insurance and/or reinsurance activities through an agent, even if the agent is not authorized to negotiate or conclude contracts on behalf of the non-resident.



In contrast, Article (4) of the Income Tax Law specifies certain places that are not considered a permanent establishment if they are used for specific purposes, as follows:

1. Storing, displaying, or supplying goods or products belonging to the non-resident.
2. Maintaining a stock of goods or products belonging to the non-resident for the purpose of processing by another person.
3. Purchasing goods or products solely for the purpose of collecting information for the non-resident.
4. Carrying out activities of a preparatory or auxiliary nature for the benefit of the non-resident.
5. Preparing contracts for signature relating to loans, supply of goods, or technical service work.

It is noted that these cases share the characteristic of not involving the actual conduct of core business activities that would otherwise constitute a permanent establishment and subjecting its activities to taxation. This indicates that a permanent establishment is deemed to exist where there is both a physical place of business of the non-resident and that place is used for carrying out substantive business activities, rather than merely auxiliary, preparatory, or incidental activities.



# Common Professional Mistakes and Practices

## Common Mistake:

Failure to verify loan interests and the extent to which they are deductible when preparing the Income Tax base.

## Correct Procedure:

Verify the allowable amount of deductible interest expense in accordance with Article (10) of the Implementing Regulations of the Income Tax Law.

## Clarification (Example):

Under the Income Tax provisions, interest expenses are generally deductible expenses subject to a prescribed ceiling. As interest expenses are commonly incurred by taxpayers, it is frequent for them to be deducted without properly verifying the allowable limit. This may result in claiming deductions in excess of the permissible amount. Accordingly, taxpayers must determine the interest expense amount and ensure its deduction from the tax base in a manner that does not conflict with the result of the allowable interest expense ceiling formula set out in the Implementing Regulations.



## Common Mistake:

Failure to consider statutory deemed rejection periods when submitting objections.

## Correct Procedure:

Treating the objection or request as rejected once the period specified in the relevant regulations—defining the deemed rejection period in the absence of a response from the Authority—has been exceeded.

## Clarification (Example):

If a taxpayer submits an objection to the Authority and no response is issued within 90 days, the objection is deemed rejected. Similarly, if a taxpayer submits a refund request for Real Estate Transaction Tax and 30 days pass without a response from the Authority, the request is considered rejected.

It is common for some taxpayers not to take such deadlines, and similar time limits, into account when dealing with the Authority. This may result in missing the statutory deadlines for objection or escalation. Accordingly, once these periods are exceeded, the taxpayer must treat the submitted request as rejected and take the necessary actions and procedures resulting from such rejection.



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