

SAUDI ARABIA | SEPTEMBER 2016

Doing Business in the Kingdom of Saudi Arabia

Introduction

As the third largest recipient of foreign direct investment in the region, not to mention its standing as the region's largest economy,¹ the Kingdom of Saudi Arabia is of significant interest to foreign investors, particularly in light of recent Government initiatives (discussed further in the final section of this article).

This article will summarise some of the key considerations for foreign investors embarking on investments in the Kingdom, which include:

- the licenses and permits required by foreign investors;
- sectors where foreign investment is restricted in the Kingdom;
- vehicles that may be used for making foreign investments;
- the strategy for exiting the investment in the future;
- Saudi tax implications;
- labour practices in the Kingdom, including compliance with "Saudisation" requirements;
- directors' obligations under Saudi law;
- availability of financing;
- the legal and judicial environment of the Kingdom; and
- the impact of "Saudi Vision 2030" and "National Transformation Program 2020".

Any discussion in this article of Saudi laws should be treated only as a general guide and not as legal advice. If you require advice on a matter relating to Saudi law, you may wish to contact one of the lawyers in our Saudi Arabian practice. Furthermore, any information contained in this article regarding tax matters should be treated as a general overview of the tax regime in the Kingdom and is not a substitute for seeking proper tax advice from duly licensed accountants.

Licences and Permits for Foreign Investment

SAGIA Licensing Requirements

Foreign (i.e., non-Gulf Cooperation Council ("**GCC**") investors are required to obtain an investment licence from the Saudi Arabia General Investment Authority ("**SAGIA**") in order to conduct their business in the Kingdom. Minimum capital requirements for SAGIA licence holders vary depending on the sector, from SAR1 million in the industrial sector, SAR25 million in the agriculture sector, SAR100 million in the insurance sector and SAR20 million in the trading sector. There are no minimum capital requirements for the service sector. SAGIA retains the discretion to impose similar requirements in other circumstances, depending on an entity's activities. Trading entities must also have a Saudi local hold at least 25% of its shares.

¹ See http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf

A SAGIA licensed company is able to:

- sponsor its employees for residency purposes;
- apply for financing from the Saudi Industrial Development Fund in cases where it is working on an industrial project;
- once established, apply for funding from the Human Resources Development Fund to assist with training and employment of Saudi employees;
- own or rent industrial land; and
- engage in the full range of activities as defined by its approved objects, work with private and public sectors and promote and solicit business throughout the Kingdom.

A company may only carry out the activities specified within its objects as approved by SAGIA. It is important to note that an object of “general commercial activity” common to European jurisdictions is not available in the Kingdom and too broad a set of objects will not be approved by SAGIA. It is possible to amend or expand the company’s objectives although the approval of all of the shareholders of the company as well as that of SAGIA and the Ministry of Commerce and Investment (“**MOCI**”) will be required.

Other Licensing and Registration Requirements

Following the issuance of a SAGIA investment licence, foreign investors must make additional registrations with certain Governmental authorities, submitting all supporting documentation in Arabic. This includes applications to:

- the MOCI for a commercial registration;
- the Ministry of Energy and Industry and Mineral Resources (for industrial companies);
- the Labour Office for the opening of a “700 file” allowing for the employment of potential employees;
- the General Organisation for Social Insurance (“**GOSI**”);
- the Department of Zakat and Income Tax (“**DZIT**”);
- Civil Defence; and
- the Municipality where the entity is to be located.

Recent Developments Benefitting Foreign Investors

In recognition of the increasing importance of foreign investment to the Kingdom’s long-term economic prosperity, the Kingdom has taken a number of steps to further open the Saudi market to foreign investment:

- In June 2015, the Saudi Capital Markets Authority opened the local stock market for trading to foreign investors and foreign investors now own just under 1% of all listed companies in the Kingdom.
- In September 2016, new qualified foreign investor rules were introduced, pursuant to which eligible foreign investors are able to own up to 10% of shares in any company listed on the Saudi Stock Exchange (the “**Tadawul**”).

- Foreign entities are now permitted to hold 100% of the share capital in wholesale and retail sector companies in the Kingdom, provided that they have a minimum share capital of SAR30 million and make a foreign investment of at least SAR200 million over a five-year period.
- SAGIA has introduced a new fast track service which guarantees decisions on licence applications within five working days, subject to additional Government approval which will be required if the entity undertakes some form of “special” activity (e.g. in the healthcare, transportation or insurance sectors).

Foreign Investment Restrictions

Foreign investors should be aware that certain investments are wholly closed to foreign nationals in any corporate form, documented on what is known as the “Negative List.” This list includes investments in religious tourism, commercial agencies and distribution, real estate brokerage, recruitment and employment and fisheries services, amongst others. A list of activities which are not open for foreign investment is set out in the Appendix.

Potential Investment Vehicles

Prior to making any investment in the Kingdom as a foreign investor, parties should first select the most appropriate corporate structure for the purposes of their investment. This may include incorporating as:

- **A branch:** This will require a minimum capital of SAR500,000 (or potentially higher in certain circumstances), but is generally the quickest type of entity to establish in the Kingdom. However, as branches operate as extensions of parent companies, their activities are limited to those which its parent entity is licensed to perform.
- **A limited liability company (“LLC”):** This entity largely resembles a private company with limited liability, and is the most common form of entity established by foreign investors in the Kingdom. It requires between two and 50 shareholders. The Companies Law allows the formation of a single shareholder LLC, subject to certain restrictions.
- **A joint stock company (“JSC”):** This entity must have at least two shareholders and there is no limit as to the maximum number of shareholders. The Companies Law permits wholly-state owned companies and companies with a minimum capital of SAR5 million to be incorporated as a single shareholder JSC. The JSC is arguably the most regulated form of corporate entity in the Kingdom. This is evident from the regulatory requirements that must be satisfied for its incorporation, the degree of involvement of MOCI in the JSC’s administration, decision-making process, its on-going filing obligations as well as the detailed legal requirements concerning the management of the JSC.
- **Other company types:** Joint ventures, joint liability companies (the equivalent of general partnerships) and limited partnership companies (the equivalent of limited liability partnerships) can also be selected.

While 100% foreign ownership is permitted in an increasing number of sectors (although please refer to the preceding section for sectors which restrict or prohibit foreign investment), there are distinct advantages to having a Saudi partner for foreign companies investing in the Kingdom, which include:

- knowledge of the local market and business practices;
- assistance in dealing with government authorities; and
- marketing and networking opportunities.

Exit Strategy

Structuring an exit strategy can pose legal challenges.

Shareholders of LLCs enjoy statutory pre-emption rights on share transfers to third parties. Shareholders may waive their pre-emption rights in favor of a third party buyer, but such waiver is difficult to enforce in practice. Any share transfer requires the cooperation of all shareholders as the share transfer is effected through:

- updating the share register; and
- signing of a shareholders' resolution amending the articles of association of the LLC before a notary public.

This means that a shareholder (irrespective of the size of their shareholding) who does not wish to sign the shareholders' resolution before a notary public can effectively block the sale. Similarly, a capital increase requires the consent of all shareholders and any uncooperative or minority shareholder can effectively exercise anti-dilution rights by not turning up at the notary public to sign the shareholders' resolution authorising the capital increase.

JSC shareholders do not enjoy statutory pre-emption rights on share transfers to third parties. Any transfer of shares of the JSC is effected through a book entry in the share register of the JSC.

Saudi Tax Considerations

Tax Residence

A company is a Saudi tax resident if it is a Saudi registered capital company or if its central control or management is based in the Kingdom.

Tax Basis

A resident company is taxed on income arising in the Kingdom. A non-resident carrying out activities in the Kingdom through a permanent establishment ("**PE**") is taxed on income arising from or related to the PE.

Taxable Income

Income tax (20%) is levied on a non-Saudi shareholder's share in a resident company's income from any activity in the Kingdom less allowable expenses. Zakat (2.5%) is levied on the Saudi shareholder's share of the company's Zakat base. Citizens of GCC countries are treated as Saudis.

Capital Gains

A 20% capital gains tax is imposed on the disposal of shares in a resident company.

Withholding Tax

Withholding tax rates vary between 5% and 20% according to the type of service performed and according to whether the beneficiary is a related party or not. These rates are as follows:

- 5% for dividends;
- 5% for interest payments;
- 15% for royalty payments; and
- 20% for management fees.

GOSI Contributions

Both the employer and employee are required to make GOSI contributions. These are the equivalent of social insurance or pension payments. GOSI payments vary depending on whether the employee is a Saudi national, non-Saudi but GCC national or non-GCC national.

Labour Practices

An employee must be provided with an employment contract. Failure to provide a written contract will result in any term of the employment agreement being interpreted in favour of the employee.

The Saudi Labour Law permits two types of contracts: term contracts and project-based contracts. Term contracts are further divided into fixed term contracts and indefinite contracts. Any contract that:

- exceeds four years;
- has no provisions for renewal but has been renewed by course of conduct; or
- has been renewed three consecutive times, becomes an indefinite contract.

The maximum number of working hours for employees is generally eight hours per day or 48 hours per week, with the exception of the holy month of Ramadan, when actual working hours for Muslim employees may not exceed six hours a day or 36 hours a week. The number of working hours may be raised to nine hours a day in respect of certain categories of employees or in certain industries and operations. The number of daily working hours may be reduced to seven hours for certain categories of employees or in certain industries or operations that are of a hazardous or harmful nature. Hours of work must be arranged so that no employee works more than five consecutive hours without an interval of rest, prayer and meals, which must not be less than 30 minutes each time. The employee cannot be required to remain in the place of work for more than 12 hours per day and in their first five years of employment employees are entitled to an annual paid leave of at least 21 calendar days. After the first five consecutive years, this period increases to 30 days.

When an employee's employment ends, the employer must pay an end-of-service benefit to the employee.

Saudi Labour Law does not allow termination of employment for no cause and termination for redundancy is highly restricted. Termination of employment for cause is subject to strict rules and procedures which, if not followed, are likely to result in compensation awards in addition to payment of damages in the amount of remaining contract salary, end-of-service benefit payment and any allowances. This is particularly important in relation to indefinite term contracts as compensation awards may be significant for wrongful termination.

Disputes are dealt with by local Commissions for Settlement of Labour Disputes and practice shows that these are generally pro-employee.

Saudisation

The Kingdom's "Saudisation" program is a broad nationalisation plan, aimed at bolstering the Saudi private sector workforce with Saudi nationals in a bid to improve youth employment. Specific percentage requirements of national employees are imposed by the Ministry of Labour ("**MOL**") on individual entities, and will depend on such entity's activities, size, and the Saudi province in which it is based. Certain positions are restricted solely to Saudi nationals, such as HR, receptionists, treasurers and civil security guards. Certain sectors have been targeted more than most, such as the mobile phone retail sector which seeks to achieve 100% Saudisation. Saudisation also requires employers to engage in training programs for Saudi nationals. In general, the greater

the number of base employees in an entity, the larger the percentage of local employees that will be required through Saudisation.

The Saudisation regulations are administered under the Nitaqat system by the MOL. Each employer is awarded a rating (red, yellow, low green, mid green, high green and platinum) that is based on specific requirements for the industry, size of the employer's enterprise and other factors. These requirements are subject to regular change. The Saudisation program is being implemented in stages and the third stage has been recently postponed until further notice. It is worth noting that the Nitaqat rating is one of the determining factors in the renewal of the SAGIA licence.

Directors' Obligations

Directors of entities in the Kingdom are not required to be nationals or residents.

Key principles of Shariah Law form the basis of directors' fiduciary duties, requiring directors to act within the scope of their authority and in the best interests of the company, to treat all shareholders fairly, and to act with all reasonable care, skill and diligence.

Directors can also be sanctioned for any wrongdoing. Under the Companies Law, directors can now face fines of up to SAR5 million and / or up to five years' imprisonment as a result of wrongful activity, such as including false or misleading information in a company's financial statements or reports or using company funds for personal gain.

Financing

Many loans in the Kingdom are Government-funded and overseen by the Ministry of Finance. The banking community is generally robust, with many commercial banks extending credit and financing to numerous businesses in the Kingdom, including foreign investors. Typically, lending occurs against corporate earnings rather than assets, due to the difficulty of perfecting security under Shariah law.

Legal and Judicial Environment

Shariah law lies at the core of the Saudi legal system, supplemented by more specific laws and regulations. Shariah law is used as an interpretative tool in the Kingdom, although there is no concept of "precedent" within the Saudi judicial system and very few publicly available legal records.

Foreign law governed contracts are traditionally difficult to apply in the Kingdom, due to the fact that the Kingdom does not apply conflict of laws doctrine. Saudi courts and adjudicatory authorities are required to apply Saudi law to any dispute litigated in the Kingdom. More importantly, foreign arbitral awards are difficult to enforce in the Kingdom; while the new arbitration law of July 2012 allows parties to choose non-Saudi governing law and international arbitration, the enforcement of foreign arbitral awards can be challenging due to the strict enforcement conditions imposed by the law (including the condition that the foreign arbitral award does not violate Shariah law) and remains an issue of concern for foreign investors.

Impact of Saudi Vision 2030

The Kingdom's "Saudi Vision 2030" and the subsequent "National Transformation Program 2020" launched in April and June 2016 respectively, were developed with the aim of propelling the Kingdom into sustainable economic prosperity, by reducing the Kingdom's reliance on oil as a source of national wealth and diversifying its economy. Through such initiatives, the Kingdom aims to raise non-oil Government revenue from SAR163 billion to SAR1 trillion by 2030, and SAGIA aims to raise foreign direct investment from SAR30 billion to SAR70

billion by 2020. As a result, foreign investors can expect the Kingdom to become an even more friendly investment environment over time and opportunities for foreign investors can be expected to rise.

Other proposals, including the privatisation of up to 146 state-owned entities in a number of industries, will allow for the purchase of Government assets and shares in Government-owned companies by foreign investors. A proposed simplification of listing processes and access to stock markets will also increase transparency and encourage foreign investment in the public market. Given the estimated total US\$4 trillion investment required for the initiatives' aims to be achieved, the scope for foreign investment in the Kingdom has undoubtedly been broadened.

Appendix

Negative List

Industrial Sector

- Oil exploration, drilling and production. Except the services related to mining sector listed at (CPC 5115+883) in International Industrial classification codes.
- Manufacturing of military equipment, devices and uniforms.
- Manufacturing of civilian explosives.

Service Sector

- Catering to military sectors.
- Security and detective services.
- Real estate investment in Makkah and Madina.
- Tourist orientation and guidance services related to Hajj and Umrah.
- Recruitment and employment services including local recruitment offices.
- Real estate brokerage.
- Printing and publishing. Except the following activities:
 - Pre-printing services internationally classified at (CPC 88442).
 - Printing Presses internationally classified at (CPC 88442).
 - Drawing and calligraphy internationally classified at (CPC 87501).
 - Photography internationally classified at (CPC 875).
 - Radio and Television Broadcasting Studios internationally classified at (CPC 96114).
 - Foreign Media Offices and Correspondents internationally classified at (CPC 962).
 - Promotion and Advertising internationally classified at (CPC 871).
 - Public Relations internationally classified at (CPC 86506).
 - Publication internationally classified at (CPC 88442).
 - Press Services internationally classified at (CPC 88442).
 - Production, selling and renting of computer software internationally classified at (CPC 88).
 - Media consultancies and studies internationally classified at (CPC 853).
 - Typing and copying internationally classified at (CPC 87505 + 87904).
 - Motion picture and video tape distribution services internationally classified at (CPC 96113).
- Commission agents internationally classified at (CPC 621).
- Audio-visual and media services.

- Land transportation services, excluding the intra-city passenger transport by trains.
- Services provided by midwives, nurses, physical therapy services and quasi-doctoral services internationally classified at (CPC 93191).
- Fisheries.
- Blood banks, poison centres and quarantines.

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