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The Professional Magazine

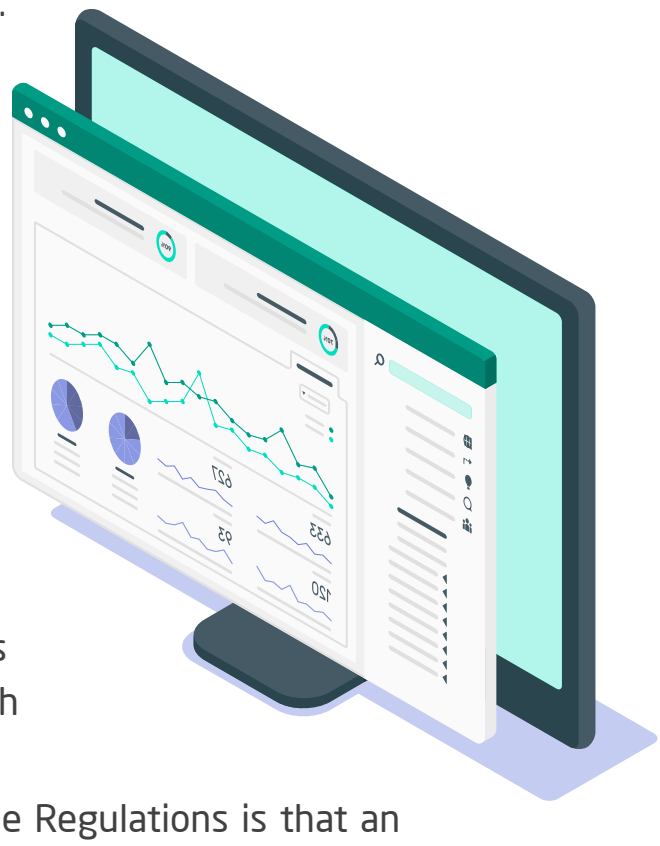
A monthly publication prepared by the Professional Research Team at Ali Al Nasser & Partners Certified Public Accountants and Consultants

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Introduction:

The Professional Magazine is a periodical published by Ali Ibrahim Al Nasser & Partners Certified Public Accountants and Consultants. In this 30th issue, we discuss the concept of trading for the purposes of deducting assets from the Zakat base. We also review some common professional mistakes and practices, most notably failure to utilize carried-forward tax losses when calculating the Income Tax base, as well as failure to distinguish between expenses recharged to a client and amounts paid in the client's name and on their behalf when calculating Value Added Tax (VAT).

The Concept of Trading for the Purposes of Deducting Assets from the Zakat Base



First: The Concept of Trading and Its Impact on the Deduction of Assets from the Zakat Base

The deduction of assets from the Zakat base is one of the fundamental procedures in calculating Zakat for Zakat Payers Holding Legal Accounts. The Implementing Regulations for Zakat Collection set out a number of provisions specifying the assets eligible for deduction, along with the conditions and controls governing such deductions.

One of the most significant controls that can be derived from the provisions of the Regulations is that an asset must not be acquired for trading or resale. The Zakat treatment of assets varies according to their nature and the purpose for which they are acquired, including whether they are held for use or long-term investment, or are intended for sale as part of the Zakat Payer's business activities.

This principle is reflected in several provisions of the Regulations, most notably:

- **Article 48:** Provides for the deduction of non-current assets and properties and their equivalents, subject to the condition that they are held for use rather than resale.
- **Article 49:** Includes among the elements of deductible fixed assets non-current investment properties that are not prepared for sale, as well as undeveloped land used in the business, provided it is not prepared for sale, pursuant to paragraphs (8) and (9) thereof.
- **Article 50:** Permits the deduction of intangible assets held for purposes other than trading.
- **Article 51:** Permits the deduction of vital assets classified as non-current assets, while excluding vital assets prepared for sale.
- **Article 42:** Explicitly establishes that investments are generally deductible only when held for purposes other than trading, subject to the specific provisions applicable to each investment.

A review of these provisions makes it clear that the purpose for which an asset is acquired is a fundamental factor in determining whether it may be deducted from the Zakat base. Merely owning an asset or including it in the statement of financial position is not, in itself, sufficient for the deduction to be accepted unless the applicable regulatory conditions are satisfied.

It should be noted that the Regulations address the concept of trading in greater detail with respect to investments item. Article 42 specifies certain circumstances and criteria for determining whether an investment portfolio is held for trading purposes. However, the Regulations do not set out comparable detailed criteria for determining the intention to trade in other deductible assets, such as investment properties and fixed assets. This is due to the particular nature of investment items, which are commonly subject to speculative trading, especially securities.

This distinction underscores the importance of examining the concept of trading specifically in relation to investments and determining their Zakat treatment accordingly.

Second: Criteria for Trading in Investments Item

Paragraph (1) of Article 42 of the Implementing Regulations for Zakat Collection stipulates the following:

"Pursuant to the special provisions of each investment in the Regulation, the investment shall be for non-trading purposes, in order to deduct the investment."

For the purposes of applying this provision, paragraph (3) of the same Article specifies the circumstances in which an investment portfolio is considered to be held for trading, namely, where any of the following circumstances applies:

1. The Zakat Payer's Business Activity Is Trading in Investments:

This criterion is met when trading in investments constitutes the nature of the Zakat Payer's business activity, as evidenced by the financial statements, statutory documents, or any other document that clarifies the nature of the activity.

Accordingly, an investment portfolio held by the Zakat Payer for speculation and trading is not eligible for deduction, even if it is classified as a non-current asset for accounting purposes.

2. Delegating Investment Management to Another Party Authorized to Buy and Sell:

An investment portfolio is considered to be held for trading if its management is delegated to another person who is not employed by the investor under an employment contract and who is authorized to make buying and selling decisions.

The Article excludes cases in which the investment management agreement stipulates that the person's role is to invest for purposes other than trading, as well as the exception relating to the fund manager of investment funds.



3. Classification of the Investment as a Current Asset:

If an investment is classified as a current asset in the Zakat Payer's financial statements, this constitutes one of the circumstances specified in the Regulations for treating the investment portfolio as held for trading.

4. Executing Successive Buying and Selling Transactions in the Portfolio:

The Regulations consider an investment portfolio listed on the financial market to be held for trading if, during the year, the Zakat Payer executes a sale followed by a purchase and then one or more further sales, or a purchase followed by a sale and then one or more further purchases, in the same portfolio.

This indicates that a single buying or selling transaction does not necessarily satisfy this criterion; rather, the sequence of transactions specified in the Article must be met.

5. An Expressed or Documented Intention, or a Decision, to Dispose of the Investment:

An investment portfolio is considered to be held for trading if the investor has expressed or documented an intention, or made a decision, to dispose of the investment, whether at a specified price or within a period of less than one year.

An example would be a decision by an authorized person to sell the investment portfolio during the year.

6. Failure to Substantiate the Holding Period When Financial Statements Are Presented in Order of Liquidity:

If the Zakat Payer presents its financial statements in order of liquidity and does not provide evidence that the investment is expected to be realized more than 365 days after the end of the Zakat year, the portfolio is considered to be held for trading in accordance with the provisions of the Article.

Scope of Application of the Trading Criteria

It is important to note that Article 42 stipulates that treating an investment as held for trading applies to the assets of the relevant investment portfolio and does not automatically extend to all investments presented in the Zakat Payer's financial statements.

Accordingly, a Zakat Payer may hold more than one investment portfolio, some held for trading and others held for purposes other than trading. The Zakat treatment of each portfolio differs depending on whether the relevant regulatory criteria and conditions are met.

Third: Determining the Intention to Trade in Other Deductible Assets

Unlike investments, for which Article 42 sets out detailed criteria for determining the intention to trade, the Regulations do not establish comparable detailed criteria for determining such intention in relation to other assets, such as investment properties, property and equipment, and other fixed assets.

Therefore, determining the purpose for which these assets are acquired requires consideration of the nature of the asset, its accounting classification, and the actual purpose for which it is held, while taking into account the specific conditions applicable to each type of asset.

In this regard, Article 9 of the Implementing Regulations for Zakat Collection stipulates that the accounting standards approved by the Saudi Organization for Chartered and Professional Accountants (SOCPA) shall apply to terminology, accounting treatments, and financial reports submitted to the Authority, unless otherwise specified.

The Article also authorizes the Authority to adjust the financial statements of Zakat Payers if their classification or presentation does not comply with the approved accounting standards. Accordingly, proper accounting classification is an important basis for determining the nature of an asset and the purpose for which it is acquired. Classifying an asset as a non-current asset, together with its use in the business, may serve as an indication that it is acquired for purposes other than trading.

However, this classification is not conclusive evidence of eligibility for deduction. It must be consistent with the nature of the asset and the actual purpose for which it is acquired, while taking into account the Authority's right to verify the accuracy of the classification and accounting treatment and whether the conditions for deduction are met. One of the most notable applications of this principle concerns investment properties.

A business may acquire a property for leasing and generating rental income, or hold land for long-term capital appreciation. In such cases, the property may qualify for deduction, provided that the remaining regulatory conditions are met.

Conversely, a business may acquire real estate for resale in the ordinary course of its activities. In such cases, the real estate does not qualify for deduction merely because it is presented as a non-current asset or classified as investment property.

The Guideline on Items of Deduction from the Zakat Base provides an illustrative example of a company that reported investment properties among its non-current assets, with a total value of SAR 177 million. These properties included real estate valued at SAR 77 million held for future use and capital appreciation, as well as other land valued at SAR 100 million acquired for resale.

The treatment set out in the guideline concluded that properties held for purposes other than sale could be deducted, whereas land held for sale could not be deducted, despite being included under investment properties item in the statement of financial position.

This example highlights the importance of distinguishing between the accounting classification of an asset and the actual purpose for which it is acquired. The inclusion of an asset within an item eligible for deduction does not necessarily mean that all its components qualify for deduction without verifying their nature.

A further distinction must be made between holding an asset to generate investment returns or achieve long-term capital appreciation and acquiring it for trading and resale. The possibility of selling an asset in the future does not, in itself, mean that it was acquired for trading purposes.

Accordingly, determining the intention to trade in assets for which the Regulations do not prescribe detailed criteria is based on proper accounting classification, supported by evidence of the nature of the asset's use and the purpose for which it was acquired, while taking into account the regulatory provisions applicable to each asset.



Common Professional Mistakes and Practices

Common Mistake:

Failure to distinguish between expenses recharged to a client and amounts paid in the client's name and on their behalf when calculating Value Added Tax (VAT).

Correct Procedure:

Distinguishing between expenses incurred by the supplier in its own name and subsequently recharged to the client, which form part of the value of the taxable supply, and amounts paid by the supplier in the client's name and on their behalf, which are excluded from the value of the supply in accordance with Article 26(6)(c) of the Unified VAT Agreement.

Illustration:

A business may incur expenses related to services it provides to a client and subsequently recover those expenses from the client. In such cases, the tax treatment varies depending on the nature of the expense and the capacity in which the business incurred it.

For example, if a consulting firm enters into an agreement with a client to provide services and incurs travel expenses for its employees to perform those services, then recharges those expenses to the client, the expenses form part of the value of the taxable supply and are subject to the same tax treatment as the underlying service.

However, if the firm pays fees or amounts owed by the client to a third party in the client's name and on their behalf, and subsequently recovers the exact amount from the client, those amounts are excluded from the value of the supply, provided that the conditions for this treatment are met.

Accordingly, merely recharging an expense to a client without adding a profit margin is not sufficient to exclude it from VAT. Rather, the determining factors are the nature of the expense and the capacity in which the payment was made.

Common Mistake:

Failure to utilize carried-forward tax losses when calculating the Income Tax base, which may result in paying more tax than legally due.

Correct Procedure:

Reviewing accumulated adjusted operating losses from previous years and utilizing them as deductions from profits in subsequent years in accordance with Article 11 of the Implementing Regulations of the Income Tax Law. This Article permits losses to be carried forward without a specified time limit, provided that the deduction in any tax year does not exceed 25% of the annual profit as reported in the taxpayer's tax return.

The applicable regulatory conditions and restrictions must also be observed, including the requirement that the losses be determined based on statutory accounts audited by a certified public accountant licensed in the Kingdom, and that the impact of changes in the company's ownership or control on its eligibility to carry forward losses be assessed.

Illustration:

A business may incur operating losses during its early years and subsequently begin generating profits in later years, yet fail to utilize its carried-forward tax losses when preparing its tax return, despite meeting the conditions for deduction.

For example, a company generates annual profits of SAR 1 million for Income Tax purposes and has carried-forward tax losses eligible for deduction amounting to SAR 2 million.

In this case, the company may deduct SAR 250,000 from its current-year profits, equivalent to 25% of its annual profit, and carry forward the remaining losses of SAR 1.75 million to subsequent years, in accordance with the applicable regulatory requirements.

Accordingly, utilizing carried-forward tax losses is a statutory right of the taxpayer. This requires monitoring their balances and verifying that the conditions for deduction are met when preparing periodic tax returns.

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