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The Impact of the Saudi Tax System on the Financing and Investment Decisions by Joint Companies

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Abstract. The Saudi Arabian tax system (zakat) has created an interesting situation for joint venture companies, because it taxes foreign partners differently from the local partner at a higher level. This system might appeal to some policy makers for two reasons. First, it gives local companies a competing edge over foreign companies. Second, it allows the country to retain part of the foreign partners' profit which will be taken outside the country.

However, this research has found that such a policy has a negative impact on co-operation between the joint venture partner. The conflict between partners might outweigh the benefits if there are any of such a policy. Also, zakat as a method of taxation was compared to income taxation (the more common method of taxation). The results indicate that zakat is more appealing from the cooperation standpoint and possesses some social benefits when compared to traditional income taxes.

Introduction

The Saudi Arabian Tax system, which differentiates between local and foreign companies in terms of the tax base and tax rates applied, represent complicated issues facing any multinational corporation operating in Saudi Arabia. Saudi Arabia is a major trading partner, not only to the U.S.A., but also to most of the O.E.C.D. member countries.

Although the local tax system made its impact on multinational, has been widely discussed in the literature [1, p. 123], [2], [3]. The particular nature of the Saudi tax system on multinational financing and investment, has not been known, discussed, or analyzed.

Foreign companies(1) operating in Saudi Arabia are taxed on a base similar to the one used by western countries (earning before taxes), with different tax rate brac-

(1) Foreign companies are allowed to operate through a joint venture or through an agent.

kets depending on the amount of the tax base. Only Saudi Arabia and the Gulf States' companies are subject to zakat(2) which consist of zakat base(3) multiplied by 2.5% to obtain the amount paid to the government. Due to the differences in the tax base component and tax rates imposed on joint companies, a conflict may arise betwen foreign and Saudi partners with respect to financing and investment decision and preferences for the method of investment and financing.

This research addresses the above issue in the following manner: first, a full description and analysis of the Saudi tax system is presented. Second, an introduction and discussion of the research objectives and methodology are given. Third, a full tabulation and analysis of the results are presented. Finally, the conclusions and recommendations of the study are introduced.

The Saudi Tax System

Saudi tax laws, like the western system, are classified into personal, corporate, and capital gain taxes. This section is divided into three subsections. Also, a brief introduciton is given for these three classes.

Personal taxes

Personal taxes are usually applied to individual income and initial investment outlay in Saudi Arabia. The individual usually calculates his tax base on the above two sources and applies a 2.5% rate on it to find the amount of zakat.

Personal income is usually obtained from three sources. First, labor income which is earned in the form of wages. Second, investment returns consisting of dividend payments or interest payments. Third, investment returns consisting of real estate rent. The two sources are not currently subject to any form of individual taxation whether it was earned by Saudi or foreign individual to avoid double taxation of the sources. However, the third source (real estate rent) is subject to zakat (approximately 2.5%)(4).

Initial investment in assets such as bonds, saving accounts, time deposits, checking accounts, and cash are subject to 2.5% zakat. This was implemented mainly to encourage investment in equity or real estate (where the initial investment is tax exempted for individuals).

(2) Religious tax imposed in Saudi Arabia, discussed in detail in the following section.
(3) The tax base includes additional items to earning before taxes.
(4) The zakat rate depends on the usage of real estate, whether it is agricultural, residential, or industrial.

Corporate taxes

Corporate taxes applied in Saudi Arabia consist of two systems. The first system, applied to Saudi and Gulf countries' companies, stems from the religious based zakat. The other draws its roots from western systems and applies to foreign companies or foreign partners in joint companies. The two systems are implemented, because zakat is a religious based duty not applicable to non-Muslims.(5)

Non Gulf foreign partners [4, pp. 82-86, 450-453] pay taxes on their share of profits earning before taxes. The tax rate is determined according to Table 1.

Table 1. Tax rates and profit classes for foreign companies in Saudi Arabia (AH 1390, 1970)

Tax rate	Profit classes (S. Riyals)
25%	0 – 100,000
35%	100,000 – 500,000
40%	500,000 – 1,000,000
45%	1,000,000 –

As mentioned above, this tax system is similar to the western system applied in the U.S.A., Germany, and England, among others. Foreign partners are authorized to use similar types of tax shields as are experienced in western countries such as depreciation, interest, and insurance without local double taxation of dividends.(6) However, Saudi Arabia is not a member of any tax treaties.(7) This may subject some foreign partners to some form of double taxation in their home countries.

Saudi and Gulf country partners(8) are subject to zakat liability, which can be calculated by multiplying the zakat base (tax base) 2.5%. The zakat base can be obtained through the following equation:(9)

$$Tct = NWt{-}1 + Et{+}LTt - NAt{-}LOt{,}t{-}1{,}. - IFt{+}NFt{-}1 + EDt \qquad (1)$$

Where:

Tct = zakat base for period t.

(5) See for example "Income tax, Road taxes and Zakat rules in Saudi Arabia" Published by the Ministry of Finance and National Economy. [4].

(6) Foreign partners don't pay taxes on dividends.

(7) See price waterhouse Guide for more details.

(8) Individual or companies.

(9) This equation does not equat net working capital. Because it includes marketable securities, earnings, and reserve for leave.

NWt–1 = Capital plus reserve and retained earning at the end of period t–1.

Et=Net earning before taxes (for Saudi partner share) for period t.

LTt = Long term debt used for long term financing at the end of period t.

NAt = Net fixed assets for period t. Under the condition set by zakat authority that NA is always less than or equal to NW + LT, and any excess amount is set to zero.

LOt, t–1,... = Net unused losses (for zakat purpose) for period t,t–1,...t–n.

EDt=Unclaimed distributed profit for period t. Unless deposited in a separate account in a bank.

IFt= Marketable securities (i.e. investment in other companies for period t for investment or liquidity purpose).

NFt –1 = Loans from owners for period t–1.

Also, the zakat minimum payment is zero. Under the law, there are no recoupment of zakat previously paid due to the occurrence of a negative zakat base, however only losses due to the companies operations can be carried forward. From the above equation, it is clear that when the company uses more long term debt,[10] it will be exposed to more zakat. This is contrary to the position of the foreign partner who is not similarly affected by such a decision, and who gains more (from the tax shield) as described below.

Capital gain taxes

Saudi investors are subject to a 2.5% tax rate (zakat) on their capital gain irrespective of its sources. All assets should be evaluated according to the market prices at the end of each fiscal year and the holder must pay a 2.5% zakat. But, in practice only realized capital gains are subject to zakat. On the other hand, any decrease in assets value can be considered a loss and can be written off. A foreign partner's realized capital gain is usually added to his profit and taxes as an element of taxable profit.

Importance of the Study

Tax as a source of market imperfection has been analyzed by several scholars (e.g. [5], [6]).In terms of the tax impact on the investment and financing decision and on the cost of capital, the research will contribute to this area in two ways. First, it

[10] The increase in debt can be used to finance current assets or reduce current liabilities.

will analyze the impact of a new and different tax scheme compared to taxing earning before taxes. Second, this research analyzes an interesting tax situation, where a country taxes local partners in a local company in a different base from the foreign partners (dual tax system). This differential tax system might be appealing to some policy makers to impose a premium on foreign investors wishing to enter the local market since his earnings will be transferred abroad. Such a policy should be analyzed in term of its impact on joint companies, its effect on the foreign and local partners, and the kind of conflict which might arise between partners due to the tax system. Finally, an examination of the rational of such a policy will be attempted.

Research Objectives

Even though zakat exists as a method of taxation in some Muslim countries, it has yet to be introduced to the western world in the frame of corporate finance. Hence this research intends to achieve the following objectives:

1) Present and analyze a new concept of taxation (zakat) to the English reader in the field of finance.

2) Study the impact of using two systems of taxation on a joint venture company and upon its financing and investment decision. Hence, it will help other countries that might impose two different tax schemes on local and foreign partners of joint venture companies, in reaching the right decision (tax the foreign partner at higher level).

3) Present the sources of conflict that may arise due to the usage of a two tax system on the joint venture companies.

4) Present a solution that may help resolve or reduce the above conflict, if such a conflict really does exist.

5) Present the system (zakat or tax) that is relatively more appropriate for the joint venture company in taking the investment and financing decision.

The Impact of the Investment Decision

The investment decision shall be analyzed from its impact on the income type tax base or zakat base. Because the benefit of such an investment will arrive to both partners, the only difference may arise from an income type tax or zakat type tax application. Since an investment decision might cause different impacts on the Saudi partner zakat base or the foreign partner tax base, the impact of investment (in all types of assets) on zakat or income type tax will be analyzed through this research.

This section is divided into three subsections. First, the impact of investment on Saudi partner zakat base is presented. Second, the impact of foreign partner tax base is analyzed. Finally, comparison of these results for the two partners will be made and inferences about the presence of differences due to the tax system on the investment decisions will be pointed.

Saudi partner

This section is centered on analyzing the investment impact on the zakat base in terms of changes in current assets, fixed assets, and depreciation. The impact of zakat (with respect to current assets, and fixed assets) is investigated from two settings. In the first setting, profit is restricted to remain constant as assets changes. Then, profit is allowed to change as assets changes. The relation between profit (earnings) and assets is assumed to be linear, because companies require a certain rate of return on their invested assets. This relation is assummed to take the following form:

$$E = BO + B1\ A \qquad (2)$$

where:

E = Profit (earning before taxes)

BO = Represent level of profit.

B1 = Rate of return on invested assets.

A = Invested assets.

Due to restriction of profit and then allowing profit to change, this section is divided into constant profit, variable profit, and depreciation to study the impact on the zakat base.

(i) Constant profit: Here, profits don't change as assets change. First, a study of the effect of changes in current assets components such as cash, marketable securities, inventory, and accounts receivable on the zakat base is presented. Then, the impact of fixed assets changes on zakat base is shown. The impact can be observed through differentiating equation (No. 1) with respect to each of the above mentioned variables. The results may be derived as follows:

$d(Tc)\ d\ (Ca) = 0$

(where d(Ca) represents the rate of change in cash)

$d\ (Tc)/d(IN) = 0$

(Where d (IN) represents the rate of changes in inventory)

d (Tc)/ d(AR) = 0

(where d (AR) represents the rate of change in accounts receivable)

d(Tc)/d (IF) = 1

(Where d (IF) represents the rate of change in marketable securities)

d(Tc)/d(NA) = 1

(Where d (NA) represents the rate of change in net fixed assets).

The previous analysis shows that the increase in cash, inventory, and accounts receivable have no impact on the Saudi partner zakat base. However, investments in marketable securities and net fixed assets have a desirable effect on the Saudi partner zakat base, it reduces the zakat base by the same amount of the investment. Therefore, this will encourage investment on such assets over other assets (given everything else is equal). However, there is a limit (upper boundary) for beneficial investment in net fixed assets not to exceed net worth and long term debt values as described above.

The previous analysis leads us to infer that investment in fixed assets and marketable securities receive a favorable tax treatment. This will give an investment in such vehicles an edge over investment in other assets such as cash, accounts receivable, and inventory. Also, this point should be taken into consideration when a company makes an investment decision.

(ii) Variable profit: In this section, profit is allowed to vary as investment in current assets and fixed assets vary. Similar items to those in the previous section are analyzed here (current assets, fixed assets, and depreciation). Differentiating equation (1) with respect to the above items (after equation two is substituted for the E term in equation one) gives the following results:

d (Tc)/ d (Ca) = B1
d (Tc)/ d (IN) = B1
d (Tc)/ d (AR) = B1
d (Tc)/ d (IF) = B1
d (Tc)/ d (NA) = B1

The above results show that the increase in cash, accounts receivable, and inventory has a positive impact on zakat base. This impact is undesirable since it means more zakat liability for the company. However, investment in marketable securities and fixed assets have a negative impact (the amount is less than the investment in them). Hence, investment in such assets shall decrease the amount of the zakat liability. Conclusions similar to those of the previous seciton can be drawn here; that zakat gives investment in marketable securities[11] and fixed assets a preferable treatment over other investment vehicles.

(iii) Depreciation: Using equation (1) and differentiating with respect to depreciation, the following result was obtained:

$$d\,(Tc)\,/d\,(D) = 0$$

(Where d (D) represents the rate of change in depreciation) zakat is neutral toward depreciation policy. Therefore, the only reason to use double declining balance, sum of the years digits, or accelerated depreciation methods over straight line depreciation is to increase cash flow.[12]

Foreign partner

A method of analysis similar to that conducted above for the Saudi partner is used here. Profits are also allowed to be constant or variable. The tax base for the foreign partner as mentioned previously is his share of earnings before taxes.

(i) Constant profit: In this case earnings before taxes remains constant as assets change. The effect of both types of assets on tax liability obtained by differentiating equation (1) was a follows:

$$d\,(E)\,/d\,(Ca) = O$$

(Where d (E) represents the rate of change in earning before taxes).

$$d\,(E)\,/d\,(IN) = O$$
$$d\,(E)\,/d\,(AR) = O$$
$$d\,(E)\,/d\,(IF) = O$$
$$d\,(E)\,/d\,(NA) = -D$$

(Where D represents amount of depreciation divided by amount of fixed assets[13] D 1).

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(11) Bonds and treasury bills are not available in the Saudi capital market for joint venture firms; however, foreign securities are deductible.

(12) This was done by Saudi cement companies to generate enough cash flow to repay government loans, instead of increasing profit after taxes and distributing it.

(13) Since earnings before taxes can be expressed as:

$$E = R - C - D\,(f\,(NA))$$

Where:

E = Earnings before taxes.

R = Revenues from operations.

C = All types of costs except depreciation and taxes.

D = Depreciation which is a function of fixed assets. =

The previous results show that as assets change the tax base doesn't change except for fixed assets. Hence, the amount of tax remains the same. However, these results were different from the Saudi partner results with respect to fixed assets and marketable securities. Therefore, a reaction due to taxes may be expected.

Researchers might argue that earnings before taxes will change as assets change. Hence, the above results might be meaningless. But in the above results, the intention was to see and isolate the effect of assets alone. The profit added effect is introduced next.

(ii) Variable profit: Profit is expected to react in the same manner (Linear relation with respect to assets). The study of the effect of current and fixed assets on earnings resulted in the following:

$$d\,(E)\,/d\,(Ca) = B1$$
$$d\,(E)\,/d\,(IN) = B1$$
$$d\,(E)\,/d\,(AR) = B1$$
$$d\,(E)\,/d\,(IF) = B1$$
$$d\,(E)\,/d\,(NA) = B1 - D$$

The previous results are different from the Saudi partner results. Again, the differential treatment is present between the two partners since the Saudi partner receives favorable tax treatment for investing in short term assets and fixed assets compared to the foreign partner.

(iii) Depreciation: The following impact on the tax base was obtained as the amount of depreciation changes:

$$d\,(E)\,/d\,(D) = -1$$

This result is different from the Saudi partner, which exhibits neutrality toward depreciation. Therefore, the conflict arises again between Saudi and foreign partner. This means that under Saudi Tax laws, the foreign partner receives a favorable treatment, hence, benefiting from different depreciaiton methods.

= Therefore:

$$\begin{aligned} D\,(E)\,/d\,(NA) &= (d\,(E)\,/d\,(D))\,(d(D)\,/d\,(NA)) \\ &= -1\,(D/NA) \\ &= -(D/NA) \end{aligned}$$

Hence the change in fixed assets will cause earnings before taxes to decrease by the rate of depreciation for every 1 S.R. of new assets.

Overall effect of investment decision

The previous results have shown that some problems will arise. However, can these results present a major source of conflict for the Saudi and foreign partners? For investment decisions in fixed assets, the Saudi and foreign partners' resutls are contradictory in two cases: First, when (D) is less than (B), then the foreign partner shall accrue more tax liabilities as the company invests in fixed assets. Second, when the company is evaluating more than one investment alternative, the tax benefit received by the Saudi investor will alter the ranking of alternatives creating a conflict of interest with the foreign partner due to the fact that projects are selected based on their rate of return after taxes.[14] Hence, the ranking of the alternatives might not be the same for both parnters. Finally, investing in marketable securities or in subsidiaries will expose the foreign partner to additional taxes while the Saudi partner receives a tax benefit.

There are a host of other issues that need to be settled through further research. These issues include:

1) How can the partners settle the previous identified conflict.

2) What type of reaction will be made by the other partner toward the domination partner?

It is noted that the conflict of interest referred to above may have surfaced only in the last few years because most joint companies are newly established and they have received a period of exemption. However, as these tax exemptions expire, the results of research to minimize the identified conflict will be of increasing importance.

The Impact of the Financing Decision

This section will be organized in a similar fashion as with the investment case. Also, the analysis of the financing decision will be looked at from its impact on the zakat or income type tax along. Here, both partners are expected to any project under consideration by the company. Hence, the only difference between them with regard to additional costs is the impact of income type taxes or zakat as appropriate. Therefore, when a decision is made with regard to using a certain financing instrument the additional effect to consider is its impact on taxes and zakat in terms of the additional cost to financing. This is so since any additional payment or saving of income type taxes or zakat will affect both partners after tax cost of financing the project.

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(14) The strength of the conflict will depend on the rate of return of alternative projects in the mother country of the foreign partner.

This section is divided into three subsections. First, the impact of the financing decision on zakat (amount paid) is presented. Second, the impact of the financing decision on income type taxes is analyzed. Finally, financing impacts on both zakat and income type taxes are compared and inferences are drawn about the existence or absence of a conflict.

Saudi partner (Zakat)

Since the Saudi partner is subject to zakat, this subsection will study the impact of different financing methods on the zakat base. These methods include equity[15], loans (short and long term), creditors (accounts receivable), owners' loans, and reserves for employees[16]. The effect of these financing methods are explored as follows:

First, financing through short term loans and creditors (i.e. current liabilities) causes the zakat base to react in the following manner.

$$d\,(Tc)\,/d\,(Ls) = -\,iLs$$

(Where d (Ls) represent the change in short term loans and or creditor financing (accounts receivable), and iLs is the cost of short term borrowing.

The increase in financing through the short term borrowing in Saudi Riyal (Saudi Monetary Unit, S.R.) will lead to a decrease of zakat base[17] by the amount of interest payment on one S.R. However, financing through owner's and external long term loans affected zakat in the following way:

$$d\,(Tc)\,/d\,(LT) = -\,iLT + 1$$

(Where d (LT) represents the change in long term loans, and iLT represents interest paid for long term loans).

$$d\,(Tc)\,/d\,(NF) = -\,i\,NF + 1$$

(Where d (NF) represents the change in owners' loans, and iNF represents interest payment to the owners).

(15) This includes capital raised, retained earning, and other reserves.

(16) This is a compensation for employees when they leave the company and not the regular pension or retirement compensations. Regular pension payments are usually paid to the government for Saudi employees and was cancelled for foreign employees recently.

(17) The decrease in zakat, equals the decrease in the zakat base is multiplied by 2.5%

The zakat base increases by the amount of (1 – iLT) due to financing by long term loans and by (1–iNF) due to financing by owners' loans[18]. Here a different tax reaction to the financing was found compared to short term financing (decrease vs. increase).

Next, equity financing led to the following reaction:

$$d\,(Tc)\,/d\,(NW) = 1$$

(Where d (NW) represents the change in equity)

Equity financing has caused the zakat base to increase by the amount of financing. This increase is larger than the increase would be if the same financing need was met by long term loans and owners' loans[19].

Finally, financing through employee reserves would cause the following effect:

$$d\,(Tc)\,/d\,(P) = -M$$

(Where d (P) represents the change in employee reserve, and M represents the ratio of amount deducted from profit to total profit).

The change in employee reserve has a negative impact on zakat base which is completely different from all of the previous methods of financing since it causes the zakat base to drop by the same amount used to form such a reserve from profit.

Foreign partner

This section will analyze the impact of the financing method on the tax base. Mainly, what will take place as a certain method of financing is used compared to another method. This subsection is organized and analyzed exactly as was the previous one (in terms of the variables analyzed). The results of the analysis are as follows:

First, short term loans and creditor financing (accounts receivable) will cause the tax base to react as follows:

$$D(E)\,/d\,(Ls) = -\,iLs$$

The foreign partner tax base has reacted in a manner similar to the reaction of the Saudi partner zakat base. Any increase in short term loans or accounts receivable will cause the zakat and income type tax base to decline by the amount of interest paid.

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(18) The zakat base will decrease only when iLT 1 and iNF 1, which is remote except in a hyper inflation situaiton.

(19) This explains the reasons behind the usage of owner's loans as amethod of financing.

Second, using long term debt (loans or bonds) and owners loans will cause the tax base to react as follows:

$$d(E)/d(LT) = -i\,LT$$

$$d(E)/d(NF) = -i\,NF$$

An interesting result was obtained here that is contradictory to the Saudi partner result. As the company uses long term debt or owners' loans, the zakat base will increase and the income type tax base will decrease. That will lead to the existence of the conflict between Saudi and foreign partner.

Next equity financing led to the following impact:

$$d(E)/d(NW) = 0$$

As the company uses equity financing, the tax base remains unaffected. Still a contradicting result is obtained since the zakat base increases as equity increases and the income type tax base remains unchanged. Similar results are obtained again.

Finally, financing through increased employee reserves causes the following reaction:

A similar reaction to the zakat base was found here, the tax base declines as the company finances through increasing employee reserves. This result is different from equity financing, and similar to debt financing (direction of effect).

Overall effect of financing decision

The previous results lead to the establishment of the existence of differences due to the tax laws imposed in Saudi Arabia for the Saudi and foreign partner with respect to using long term debt and owners' loans and equity in financing. Even though both partners gave lower preferences to equity and long term debt and owners loans in terms of cost of financing and tax or zakat saving (see Table 2,3,4,5). The foreign partner is indifferent with respect to long and short debt (assuming both cost the company the same). Hence the difference in costs between long and short term (the second is lower) may cause one partner to choose short term while the other chooses long term as a method of financing. To resolve such a conflict, either the majority stock holder will impose his solution or a unified tax sytem should be imposed.

Some readers may point out that the order of preferences is to a degree similar across partners. However, the cost of these methods of financing are sufficiently different for both partners that it may cause an overlap resulting in a similar situation to short and long term debt financing (mentioned above). Also, a different set of pre-

Table 2. Order of investment and financing method based on their impact on zakat base

Investment			Financing		
A. Fixed profit					
Order	**Method**	**Impact**	**Order**	**Method**	**Impact**
1	Fixed assets and marketable securities	-1	1	Short term loans and account receivable and employee reserve	$-i_{LS}$ $-M$
2	Other current assets	0	2	Long term loans and owners' loan equity	$-i_{LT}+1$ $-i_{NF}+1$
			3	Equity	$+1$
B. Variable profit					
1	Marketable securities	-1			
2	Fixed assets	B_1-1			
3	Other curent assets	B_1			

Table 3. Order of investment and financing method based on their impact on the tax base

Investment			Financing		
A. Constant profit					
Order	**Method**	**Impact**	**Order**	**Method**	**Impact**
1	Fixed assets	$-D$	1	Current liabilities and long term loans and owners' loans and employee reserve	$-i_{LS}$ $-i_{LT}$ $-i_{NF}$ $-M$
2	Current assets	0			
B. Variable profit					
1	Fixed assets	$-D+B_1$			
			2	Equity	
2	Current assets	B_1			

Table 4. Cost of financing after Zakat for Saudi partner

Order of preference	Method of financing	Cost after Zakat	Direction of change
1	Employee reserve	-2.5%	
2	Current liabilities	$i_{LS}(1-2.5\%)$	+
3	Long term loans	$i_{LT}(1-2.5\%)$	+
	Owners' loans	$i_{NF}(1-2.5\%)$	+
4	Equity	$K_e + 2.5\%$	+

Table 5. Cost of financing after Zakat for foreign partner

Order of preference	Method of financing	Cost after tax	Direction of change
1	Employee reserve	$-TR$ *	–
2	Current liabilities	$i_{LS}(1-TR)$	+
	Long term loans	$i_{LT}(1-TR)$	+
	%Owners' loans	$i_{NF}(1-TR)$	+
3	Equity	K_e	+

* applicable tax rate

ferences of the method of financing may exist (see Table 3,4) between partners. Finally, the resulting final cost to finance projects will be different for both partners for equity and long term debt, which will cause one partner to reject and the other partner to accept the same project at the samt time. For example, the cost of equity after tax for the foreign partner might be lower than to the Saudi partner and equal to debt financing.

The Interaction of Investment and Financing Decision

Modeglini and miller [7] have shown that we can separate between investment and financing decision. However, can we separate between investment and financing decision in the presence of zakat? (for example the increase in long term debt can be used to finance current assets without affecting zakat). The answer to such a question is yes for two reasons: First, the zakat equation does not include all assets and liabilities, and reserve for leave. Therefore an increase or decrease in long term debt, equity, or fixed assets can be channeled through current assets, current liabilities, or reserve for leave. Finally, there is a time lag between the variables in the zakat equation which allow us to separate between financing and investment decisions.

Tax and Zakat Minimization

The question remains to be answered: which method of taxation will benefit the company by minimizing the amount of money to be paid to the government? Before answering the previous question two points are in order. First, the Saudi government doesn't give any refund for tax or zakat, but operating losses can be carried forward and deducted from future year's tax base computations [4]. Second, all Saudi and joint venture companies retain unclaimed distributed profits in a separate bank account to avoid payment of zakat on them.

In order for the Saudi partner to avoid paying any zakat equation one should be less than or equal zero.

$Tct\ 0$

i.e.

$$NWt-1 + Et + LTt - NAt - LOt, t-1, .. -IFt + NFt + EDt + O$$

Subject to the condition: $NWt - 1 + LTt\ NAt$

This goal can be achieved by satisfying the following relation:

$$IFt + NAt + LOt, t-1, \ldots Et + NWt - 1 + LTt + NFt$$

$$S.T\ NWt - 1 + LTt\ NAt$$

Under the assumption of no past losses and the placement of unclaimed distribution profit in a suitable bank account, this becomes:

$$IFt + NAt\ Et + NWt - 1 + LTt + LTt$$

In order to pay zero zakat, the company must invest in marketable securities and net fixed assets equivalent to the above amount and finance these investments through other sources not included on the right side in the above equation (current liabilities and employee reserves).

On the other hand, to achieve a zero tax the firm should have previous losses or zero profit before the current period. This might be a disadvantage to income type taxes compared to the zakat tax. The company has less desirability to claim or show losses which may adversely effect its market value. Hence, without any losses the foreign partner will be subject to taxes while the zakat payer can set his taxes to zero regardless to the profit situation of the company. Also, a conflict may arise between partners when the Saudi partner tries to set the zakat liability to zero, especially when the rate of return on marketable securities is less than the cost of financing by less than 2.5% (zakat rate).

Comparison of the Two Methods of Taxation

The comparison between the two tax systems is based on its incentives to invest in assets (whether it is good for both the economy and the joint venture), its ability to minimize taxes paid, its effect on the financing decision, and its impact on dividend policy. *First,* the zakat system encourages the Saudi partner to invest in marketable securities over cash, while income type taxes do not differentiate between the two assets. This encouragement has more than a positive side for society in terms of a healthy active capital market due to the involvement of joint ventures for tax purposes. Also it gives a tax benefit for joint ventures and helps to reduce the tax burden on them. This result gives an added support to zakat over income type taxes for the benefit it creates for the society.

Second, zakat favors investment in fixed assets compared to income type taxes due to the associated tax benefits given to the zakat payer. This may create a problem in evaluating a project due to the added incentive. However, such an incentive might be beneficial to society in terms of stimulating more investment and creating job opportunities in the process.

Third, income type taxation is more affected by the method of depreciation employed by the company while zakat is neutral toward any method used by the company. The company might wish to increase its cash flow and pay lower taxes in the current period and in return it will pay higher taxes and realises lower cash flow in future periods. This is not the case with zakat, where changes in the size of the cash flow in current and future periods will not be affected by the size of the zakat liability.

Fourth, zakat encourages the distribution of profits over retaining it, since equity is considered the least preferable source of financing and it will increase the size of zakat by 2.5% times the magnitude of financing. On the other hand, income type taxes are not effected by retaining or distributing earnings (dividend policy). This seems to effect the preference of zakat over taxes. However, according to finance theory [8, p. 545] there exists a positive relation between dividend payments and company value under certain assumptions. So this bind is not a negative one and it may help enhance the company's value in the right direction[(20)].

(20) Brealey and Myers have cited several studies, that shown personal taxes as one of the reasons behind the irrelivancy of dividend policy. Since, personal taxes are not imposed on individual in Saudi Arabia, dividend policy might be relevant.

Fifth, the zakat liability can be reduced to zero for any company and its profit need not to be zero or negative. In order for income type taxes to be zero the company's profits (including carry forward and carry back provisions) should be zero or negative, which may effect the companies value. This would make zakat the attractive choice over taxes from the joint venture point of view.

Sixth, zakat gives a higher preference for current liabilities and employee reserve and to a lesser degree fixed liabilities. On the other hand, income type taxes gives fixed liabilities a higher preference compared to current liabilities under the assumption that long term interest rates are higher than short term rates. This may create a conflict in project evaluation and strength on the need for a unified tax system.

Finally, equity financing has a zero impact on taxes, while it has a positive impact on zakat as shown previously. This substantiates the need for a unified tax system to avoid any conflict or additional cost. However, both methods of taxation are consistent in giving debt higher preference over equity due to tax advantages.

Conclusion and Recommendations

The previous analysis has shown the existence of differences and a conflict between the Saudi and foreign partner in a joint venture firm. This implies that the partner with control over the investment and financing decisions will dictate his decision over the other partner. Therefore, the existence of such a problem might cause the weaker partner to demand a premium or some other sort of guarantee to protect himself from any additional cost caused by the tax system. This will support the imposition of a uniform tax system for both partners instead of the current system which places the two partners under significantly different tax systems.

Both systems of taxation have been analyzed and their points of strength and weakness have been presented. Even though the zakat tax system appeals more to joint ventures and society, further research is needed to determine the best tax system for the economy at the macro-economic level.

Now that this research has established the conflict between Saudi and foreign joint ventures partners using a simple financial model of the firm, future research on this issue using a more sophisticated models of the firm appears to be warranted.

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أثر النظام الضريبي السعودي على قرارات الاستثمار والتمويل في المشروعات المشتركة

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ملخص البحث. خلق النظام الزكوي الضريبي في المملكة العربية السعودية وضع جديد غير متواجد في الدول الأخرى لفرضها ضرائب مرتفعة على الشريك الأجنبي مقارنةً بالشريك المحلي. ربما يرى بعض السياسين أن هذا النظام جيد. وذلك لإعطاء الشركات المحلية الفرصة الأكبر في المنافسة مقارنةً بالشركات الأجنبيّة ولسماحها للدولة بالاحتفاظ بجزء إضافي من أرباح الشركات الأجنبية العاملة والتي ستحوّله إلى خارج الدولة.

قام هذا البحث بإيضاح الجانب السلبي لمثل هذا النوع من السياسة على التعاون بين الشريكين في الشركات المشتركة فالاختلاف بين الشركاء قد يذهب المنفعة المتوخاة من مثل هذه السياسات. كذلك تم مقارنة الزكاة مع الضريبة وأظهرت النتائج أن الزكاة أكثر قبولاً من وجهة نظر الشركات مقارنةً بالضرائب.