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Transfer Pricing in KSA and its Effects on Regional Headquarters in the UAE

LEGAL BRIEFING (7 Jan 2019)

Transfer Pricing (TP) is a set of rules that govern intercompany transactions and how they are treated from a corporate income tax point of view. The Kingdom of Saudi Arabia (KSA) has recently published its draft Transfer Pricing By-Law in order to implement the Organisation of Economic Development's (OECD) Base Erosion and Profit Shifting (BEPS) recommendations on TP. This legal briefing gives an overview of the effects KSA's new transfer pricing regime has on intercompany transactions.

1. *What is transfer pricing?*

Transfer pricing is an accounting practice that refers to the setting of prices of goods and/or services that are exchanged among the subsidiaries, affiliates or commonly controlled companies or legal entities that are part of the same larger enterprise (Controlled Transactions). Controlled Transactions may target relocating profits within a group of companies from high tax jurisdictions to a tax heaven by invoicing an affiliate (at an artificially increased price). In order to prevent artificial profit shifting, controlled transactions should comply with the so-called arm's length principle (ALP). The ALP states that the amount charged by one related party to another for a given product and/or service must be the same as if the parties were not related (*i.e. as if the parties were to procure services or goods on the open market*).

2. *Why have the transfer pricing regulations been adopted now?*

The General Authority of Zakat and Tax (GAZT) published its draft Transfer Pricing By-Laws (Draft By-Laws) on 10 December 2018.[1] The Draft By-Laws are part of the Kingdom of Saudi Arabia's (KSA) commitment to implement the Organisation of Economic Development's (OECD) Base Erosion and Profit Shifting (BEPS) recommendations on TP. The BEPS initiative ensures that profits are taxed where economic activities take place and value is created. The Draft By-Laws remain available for public comments until 9 January 2019.

3. *What are the features of the Draft By-Laws?*

The Draft By-Laws define the applicable methods (a.) and documentation (b.) requirements:

a. *Transfer Pricing Methods*

- Comparable Uncontrolled Price Method;
- Resale Price Method;
- Cost Plus Method;
- Transactional Net Margin Method; and
- Transactional Profit Split Method.

Other transfer pricing methods may be adopted. This, however, requires that the taxable person can prove that none of the

[1] An English Translation of the Transfer Pricing By-Laws can be retrieved from the General Authority of Zakat & Tax's website: <www.gazt.gov.sa/sites/default/files/2018-12/180911_BYLAWS_TP_ENG_PCV_v.012%20(12.05).pdf>.

aforementioned methods provide a reliable measure of an arm's-length result for the relevant transaction.

b. Documentation

The Draft By-Laws require that taxable persons provide the following:

- Disclosure Form of the Controlled Transaction;
- Master File;
- Local File;
- Country by Country Report (CbCR).

The Draft By-Laws require taxable persons to submit Disclosure Forms along with the income tax declaration which include the following information.

The Master File must lay out the following aspects:

- Organizational structure (*ownership structure and location of operating entities, etc.*);
- Description of the business (*drivers of business profit, supply chain, important service arrangements, etc.*);
- Intangibles (*among other things, list of intangibles that are important for transfer pricing purposes*);
- Intercompany financial activities;
- Financial and tax positions.

A Local File should be maintained at all times and be submitted to GAZT within 7 days after request. The Local File should include the following information:

- Organizational structure (*management structure, description of the business and business strategy, etc.*);
- Description of Controlled Transactions (*amount of intra-group payments and receipts, copies of all intercompany agreements, indication of the most appropriate transfer pricing method, etc.*);
- Analysis of the taxable person's industry *(major competitors, demand and supply trends, market share, etc.*);
- Financial information (*annual financial statements, etc.*).

The draft contains exceptions for maintaining the Local file and the Master file. Exempted from these obligations are:

- Natural persons;
- Small Size Enterprises (SME);
- Legal persons who do not enter into Controlled Transactions, or who are a party to Controlled Transactions where the aggregate arm's-length value does not exceed SAR 6 m (approx. EUR 1.4 m) during any 12-month period.

Parent entities may be required to file a Country by Country Report (CbCR). CbCR aims at ensuring that adequate taxes are paid in the jurisdiction where profits are generated, value is added, and risk is taken. The CbCR should be submitted no later than 12 months after the end of the concerned reporting year. In essence, the CbCR breaks down key elements of the financial and tax information relating to the global allocation of multi-national companies' income and taxes by each jurisdiction they operate in.

4. What are the measurements KSA tax authorities can take under the Draft By-Laws? How are UAE operations affected?

While the Draft By-Laws do not contain any penalties, the tax authorities have the power to adjust the transfer price: where the price is not complying with the arm's length principle, GAZT may adjust the tax base accordingly. This may result in higher tax liabilities if part of a tax deduction is rejected or if it is considered that the KSA entity should have charged a higher price to its foreign affiliate.

Companies that have their regional headquarter in the UAE need to keep in mind that any Controlled Transaction with an affiliated company in KSA will have to comply with the TP. The respective intercompany transactions must comply with the approved transfer pricing methods and the documentation requirements must be prepared in accordance with the aforementioned requirements.

It should be also noted that that the UAE have recently committed to introduce a CbCR by joining the OECD's Inclusive Framework on Base Erosion and Profit Shifting (BEPS) in 2018. According to Art. 13 the UAE will need to update their domestic legal and regulatory framework to allow for the collection and sharing of information and CbCR requirements.

5. Conclusion

It is expected that the Draft By-laws will be implemented in 2019. Based on that TP requirements may be applicable already to the fiscal year ending on 31 December 2018.

GAZT has installed a tax unit for TP. Hence, it is expected that GAZT is well prepared to review TP arrangements. Concerned companies will, therefore, need to make themselves familiar with the TP requirements and ensure the following:

- Complying with documentation requirements (*Disclosure Form, Master File, Local File and CbCR*);
- Reviewing and/or putting in place intercompany agreements that reflect the TP requirements; and
- Ensuring that supporting documentation is stored (*e.g. emails, internal memoranda, proof of delivery, etc.*).

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