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INSIGHT: Saudi Arabia Revises Transfer Pricing Guidance (Part 1)

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June 29, 2020, 8:00 AM

In Part 1 of this two-part series, Shiv Mahalingham draws on some of the key elements of the KSA Transfer Pricing Guidance (second edition) which will assist multinational enterprises operating in the region.

The General Authority of Zakat and Tax (GAZT) released the second edition of Transfer Pricing Guidance in May 2020 (The Updated Guidance). There are no surprises in this second edition; however, there are many helpful additions to/clarifications of the existing Transfer Pricing Bylaws.

The Updated Guidance is substantial at circa 350 pages and is organized into the following chapters:

1. Introduction
2. What is Transfer Pricing?
3. Subjects
4. Comparability Analysis
5. Transfer Pricing Documentation
6. Implementation
7. Financial Transactions
8. Intangibles
9. Business Restructuring
10. Valuation Approaches

11. Permanent Establishments

12. Audit and Risk Assessment

This article sets out a summary of the important elements of each of the above chapters. Note that there are some helpful appendices in the Updated Guidance that will assist multinational enterprises (MNEs) to comply with the Kingdom of Saudi Arabia (KSA) Transfer Pricing Regulations. These appendices will be covered in Part 2 of this article.

Chapter 1—Introduction

There are no changes to the force of law from the pre-existing Transfer Pricing Bylaws (issued January 2019) and first edition of the Transfer Pricing Guidance (issued March 2019). Transfer pricing continues to apply to all taxpayers subject to the KSA Income Tax Law (Issued by Royal Decree (M/1) dated 15/1/1425H).

Zakat entities continue to be exempt from transfer pricing documentation requirements except for country-by-country reporting.

The Updated Guidance remains non-binding; however, it is helpful in assessing how the GAZT will apply transfer pricing in practice and this has been evidenced in transfer pricing audits in the past 12 months. The OECD Transfer Pricing Guidelines have been leveraged/referenced and will be important in interpreting any areas that the KSA Bylaws do not address. The GAZT confirm in the introduction chapter that tax rulings are available for subjective/complex areas. Whilst non-binding, a number of MNEs have already put in place such a ruling (the process takes two–three months) as this will certainly minimize audit issues in the future where the parameters of the tax ruling are respected.

Chapter 2—What is Transfer Pricing?

Chapter 2 sets out the definition of transfer pricing and the most likely transactions to be covered (goods, services, loans and intangibles). The chapter highlights the important of commercial dealings and market forces in determining prices that will decide the amount of taxable profits in KSA. A step plan is also set out for MNEs (similar to the step plan set out in the Egypt Transfer Pricing Guidelines):

1. subject—identify the entities/transactions that are within scope;
2. comparability analysis—identify and delineate transactions;
3. testing—appropriate transfer pricing method;
4. documentation—demonstrate the arm's length nature of transactions;
5. implement—whilst this is always an important step, the Affidavit requirement brings this into focus.

Chapter 3—Subjects

The wide-reaching effective control tests remain (control by governance, funding and business).

It is clarified that the Transfer Pricing Regulations apply to juridical persons only including permanent establishments (PEs). Natural persons will still need to be considered when assessing actual control relationships for juridical persons.

Mixed entities remain subject to the Transfer Pricing Regulations on a pro-rata basis to the percentage of ownership.

It is confirmed that the Transfer Pricing Regulations (may) continue to apply even if there is no legal ownership in place (an economic relationship is sufficient to create a control relationship). One important clarification is that effective control is a rebuttable and MNEs may be able to demonstrate that no effective control exists based on facts and circumstances.

Chapter 4—Comparability Analysis

This chapter lists some of the key areas to consider when assessing comparability at the initial high level:

1. industry sector;
2. business strategies;
3. markets;
4. industry practices;
5. characteristics of the products/services;
6. supply chain;
7. high level assessment of key functions, assets and risks.

A deeper dive, following the preliminary analysis will follow the six factors (recall that risk has been elevated to a separate factor of comparability in comparison to the OECD five factors listed in Chapter 1 of the OECD Transfer Pricing Guidelines) of comparability as set out in the first edition of the Updated Guidance:

1. contractual terms—written contracts remain critical to assess responsibilities, risks and outcomes. Email correspondence is also of importance;
2. functional analysis—to capture the economic substance of transactions and actual conduct (the Guidance sets out some sample functional interview questions);
3. analysis of risks (applying the OECD “six-step” process of: identification, contractual assumption, management, actual conduct, financial capacity, pricing);
4. characteristics of the property/services;
5. economic circumstances of the market (this includes geography, stage in the process e.g. retail v wholesale, date/time, stage in the cycle);
6. business strategies pursued (includes innovation, appetite for risk, diversification, approach to regulatory environment etc.).

The Updated Guidance confirms that the median of tested results will be expected by the GAZT unless there is economic support for a departure from the median.

Chapter 5—Transfer Pricing Documentation

There are no changes to the four-tier approach to documentation: Disclosure Form, Local File, Masterfile, Country-by-Country Report (CbCR).

It is confirmed that the requirements will continue to apply to domestic transactions with KSA and that the GAZT can and may request documentation where there are transactions with special economic zone entities or entities otherwise exempt from income tax. In these instances, the degree of tax risk will be important (i.e. has there been a potential shift of profits through transfer pricing to reduce taxation).

Experience with audits demonstrates that a copy of the transfer pricing policy and intra-group agreements is also requested. It is confirmed that multiple local files can be prepared for multiple entities or one local file covering a group of entities if practical to do so.

PEs must be listed in the CbCR and the chapter also sets out helpful clarifications on how the CbCR and the Disclosure Form can be prepared in practice. It is also confirmed that for the purpose of the Affidavit that a “limited” or “reasonable” assurance certificate may be acceptable depending on the situation (in practice this may be relevant for groups with a high volume of intra-group transactions).

Chapter 6—Implementation

This chapter highlights some important practices that will help MNEs ensure that the TP Policy is being adhered to:

1. recording of transactions with accounting systems;
2. monitoring transfer pricing throughout the year with periodic adjustments to avoid large year-end adjustments;
3. tax adjustment versus accounting adjustments.

Chapter 7—Financial Transactions

Chapter 7 covers specific clarifications for the following transactions in line with the OECD Guidelines:

1. loan transactions (lender and borrower perspectives, importance of creditworthiness and collateral, disregarding/re-qualifying the loan would only relate to “extreme cases”;
2. guarantees (contractual terms versus commercial reality/reason);
3. cash management (interest, cash management fee, appropriate split of advantages, short- versus long-term considerations);
4. factoring (contractual terms, risks, actual conduct, appropriate split of advantages);
5. securitization (appropriate return on equity);
6. hedging (management of risks and financial capacity to take them on);
7. captive Insurance (allocation of benefits to the MNE).

Chapter 8—Intangibles

Chapter 8 sets out the OECD DEMPE (Development-Enhancement-Maintenance-Protection-Exploitation) functions relevant to assessing intangibles. Contractual arrangements are confirmed to be the starting point before assessing functions, assets and risks. The Updated Guidance confirms that certain elements are not to be considered intangibles (for example group synergies, market specific advantages and the assembled workforce in place that may form part of the definition of intangibles in other locations). Note that these may impact the value of an intangible and so should not be discounted from consideration.

The Updated Guidance sets out the following suggested approach:

1. identify the intangibles;
2. identify the economically significant risks for DEMPE;
3. identify full contractual arrangements;
4. identify the person(s) performing the functions, using assets, managing risks to establish de facto ownership;
5. confirm consistency between actual conduct and contractual terms;
6. determine controlled transactions;
7. determine price.

Chapter 9—Business Restructuring

This chapter sets out the types of business restructuring that may be relevant for transfer pricing purposes to include centralization, rationalization, specialization or de-specialization of functions. The three key areas for consideration will be:

1. determination of transactions before and after the change;
2. business reasons and expected benefits (and restructuring costs);
3. options realistically available.

The Updated Guidance is measured setting out the importance of the commercial drivers. The Updated Guidance also discusses the arguments for and against a compensation payment for reduced profits and also recognizes that in many circumstances, a local entity subject to commercial restructuring is being relieved from being loss-making as opposed to forgoing profits.

Chapter 10—Valuation Approaches

This chapter confirms the importance of valuations in assessing transfer pricing, in particular discounted cash flow analysis and key variables:

1. realistic and reliable financial projections;
2. growth rates;
3. discount rates;
4. useful life;
5. tax impact;
6. consideration of terminal values.

The chapter confirms the important of a two-sided analysis of the relevant parties, treatment of routine functions and also periodic adjustments to the transfer pricing based on review of actual results where appropriate.

Chapter 11—Permanent Establishments

There have been a number of PE challenges raised since the introduction of transfer pricing regulations in KSA in January 2019—some of these are going back a number of years and the advice for MNEs is to review and self-assess PEs where possible so that a fair arm's length allocation of profits can be attributed. Chapter 11 sets out a number of important clarifications when assessing PEs to include:

1. separate entity approach;
2. concept of PE arm's length "dealings" with the MNE;
3. significant people functions approach.

Chapter 12—Audit and Risk Assessment

The chapter is short but sets out an important sentiment: addressing the Updated Guidance will put MNEs in a strong position to defend their transfer pricing.

A summary of the appendices will follow in Part 2 of this article.

In Summary

The detailed second edition of the KSA Transfer Pricing Guidance issued at the end of May 2020 will assist MNEs that are operating in the region. There are no surprises in the Updated Guidance and no substantive changes to the pre-existing Transfer Pricing Bylaws.

Audit experience to date has confirmed that GAZT will consider valid economic arguments that reference the Transfer Pricing Bylaws and Transfer Pricing Guidance; however, it continues to be imperative to respect key local requirements if MNEs wish to avoid lengthy disputes and challenges (including to historic years).

The disruption being faced by MNEs in 2020 (e.g. financing, personnel, losses) will become the subject of transfer pricing audit challenges in 2021—the Updated Guidance provides a helpful framework for MNEs to construct robust documentation to minimize disputes and to agree tax rulings with GAZT to clarify key areas.

Part 2 will cover the appendices to assist MNEs to comply with the KSA Transfer Pricing Regulations.

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