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INSIGHT: Saudi Arabia Revises Transfer Pricing Guidance (Part 2)

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In Part 2 of this two-part series, Shiv Mahalingham discusses the Kingdom of Saudi Arabia (KSA) Transfer Pricing Guidance (second edition), specifically the detailed appendices with key elements that multinational corporations operating in the region should be aware of.

The General Authority of Zakat and Tax (GAZT) released the second edition of Transfer Pricing Guidance in May 2020 (the Updated Guidance). The Updated Guidance is substantial at circa 350 pages with a detailed appendices.

There are no surprises in this second edition, as set out in Part 1 of this article, however, there are many helpful additions to/clarifications of the existing Transfer Pricing Bylaws.

The Appendices to the Updated Guidance are organized as follows:

1. Example of a Mixed Company
2. Application of the Internal CUP Method
3. Application of the External CUP Method
4. Application of the Resale Price Method
5. Application of the Cost Plus Method
6. Application of the Transactional Net Margin Method
7. Application of the Profit Split Method
8. Minimum requirements of the masterfile

9. Minimum requirements of the local file
10. Country-by-Country Reporting Template
11. User Manual for the Transfer Pricing and CbCR Form
12. Example for Intangibles (1)
13. Example for Intangibles (2)
14. Example for Intangibles (3)
15. Business Restructuring—Risk
16. Business Restructuring—Distributors

1. Example of a Mixed Company

The Appendix confirms that domestic intragroup transactions are subject to the transfer pricing regulations and that mixed companies (i.e. owned by Saudi and non-Saudi persons) will be subject to the regulations if they are subject to income tax in KSA. Mixed companies may be subject to income tax rates that differ from other types of entity in KSA and as such intra-group transactions will come under scrutiny unless there is robust support in place for the transfer prices applied.

2. Application of the Internal CUP Method

The following example is provided:

1. Company X and Company Y are related persons part of the same multinational enterprise (MNE) group;
2. Company X sells goods to Company Y at 20 riyals (\$5) per unit;
3. Company X sells goods to Company Z (unrelated/independent person) with a 10% volume discount based on the quantity purchased.

The example concludes that (after a review of all comparability factors) the intra-group price for sales to Y should be adjusted to the internal Comparable Uncontrolled Price (CUP) price. Clearly the facts of each case are important (for example the quantity of goods sold).

3. Application of the External CUP Method

The following example is provided:

1. Company X and Company Y are related persons part of the same MNE group;
2. Company X sells goods to Company Y at 20 riyals per unit;
3. independent persons enter into similar transactions at a sale of 18 riyals per unit;

The example concludes that it may be difficult to find a comparable situation in practice; however, (after a review of all comparability factors) the intra-group price for sales to Y should be adjusted to the external CUP price. Clearly the facts of each case are important (for example the economically relevant characteristics between Company X and the independent seller).

Comparability adjustment examples listed in the Appendix include:

1. quantity discounts;
2. delivery terms;
3. contractual terms;
4. minor product differences.

The Appendix also states that some adjustments may be “impossible” to account for with adjustments:

1. geographical market;
2. branding or valuable intangibles;
3. functional differences;
4. significant contractual differences.

Finally, the Appendix concludes that a range of results from external databases would be required to satisfy the arm's length principle.

4. Application of the Resale Price Method

The following example is provided:

1. Company X and Company Y are related persons part of the same MNE group;
2. Company X sells goods to Company Y and Company Y reports a gross profit margin of 25%;
3. Company Y sells goods to a third-party customer for 1000 riyals per unit;
4. Comparable independent persons (to Y) buy similar goods from independent persons and sell these to third party customers realizing margins of 17%–27%.

The Appendix concludes that in the above example no transfer pricing adjustment will be required.

5. Application of the Cost Plus Method

The following example is provided:

1. Company X and Company Y are related persons part of the same MNE group;
2. Company X manufactures goods and sells these to Company Y who is the IP owner and distributor of the products to third party customers. Company X is a “contract manufacturer”;
3. the direct and indirect product costs incurred by Company X for production of the semi-finished goods are 8 million riyals;
4. comparable independent persons manufacture similar goods for independent persons and realize a cost plus mark-up of 42%–46%.

The Appendix concludes that in the absence of reliable comparability adjustments, a transfer pricing adjustment would be required to take Company X into the arm's length range of 42%–46%.

6. Application of the Transactional Net Margin Method

The following example is provided:

1. Company X and Company Y are related persons part of the same MNE group;
2. Company X is the only supplier of goods to Company Y;
3. Company X manufactures goods as the IP owner and Company Y is a routine distributor to third party customers.

The Appendix concludes that the Transactional Net Margin Method can be applied to the results of Company Y to assess whether the net profit is at arm's length subject to an appropriate profit level indicator. In the example, Company Y has an operating profit margin of 2% compared to comparable results of 4% to 6% thus requiring an adjustment to the intra-group price charged to Company Y.

7. Application of the Profit Split Method

The following example is provided:

1. Company X, Company Y and Company Z are related persons part of the same MNE group;
2. Company X designs and manufactures a component that is shipped to Company Y;
3. Company Y designs and manufactures the rest of the product;
4. Company Z distributes the product after Company Y charges a finished product transfer price to Company Z.

The Appendix argues that "the relative amounts of R&D expenditure reliably measure the relative value of the companies' contributions." Therefore, after deducting routine profit (the example provided is 10% of manufacturing costs for Company X and Company Y) from total profit, Company X and Company Y would receive a residual profit split in the ratio of their respective R&D expenditure (3:2 in the example provided).

8. Minimum Requirements of the Masterfile

The Appendix sets out the following minimum requirements that GAZT will expect to see in the masterfile:

1. a. Organizational structure (legal and beneficial ownership and geographical locations);
2. b. Description of the MNE business to include:
 1. i. Drivers of profit
 2. ii. Supply chain
 3. iii. Important service agreements within the MNE
 4. iv. Main geographical markets
 5. v. Functional analysis and contributions to value of entities in the group
 6. vi. Business Restructurings
3. c. Intangibles
 1. i. Description of strategy
 2. ii. List of intangibles
 3. iii. Important intra-group agreements
 4. iv. Transfer pricing policy
 5. v. Any important transfers
4. d. Intra-group financial transactions
 1. i. How the group is financed
 2. ii. Central financing function if any
 3. iii. Transfer pricing policy
5. e. Financial and tax positions
 1. i. Annual consolidated financial statement
 2. ii. Advance Pricing Agreements (APA)/tax rulings in force

9. Minimum Requirements of the Local File

The Appendix sets out the following minimum requirements that GAZT will expect to see in the local file:

1. a. Taxable person's information including:
 1. i. Management structure and persons to which the taxable person's management reports to (including locations)
 2. ii. Description of the business and business strategy, restructurings, transfer of intangibles
 3. iii. Key competitors
2. b. Documentation on material-controlled transactions:
 1. i. Description
 2. ii. Amount
 3. iii. Related persons
 4. iv. Copies of intra-group agreements
- v. Comparability and functional analysis of the taxable person and relevant related persons
- vi. Most appropriate transfer pricing method

vii. Selection of the tested party

1. viii. Summary of important assumptions
2. ix. Reasons for a multi-year analysis if relevant
3. x. List and description of selected comparables
4. xi. Description of comparability adjustments if any
5. xii. Transfer pricing conclusion
6. xiii. Summary of financial information
7. xiv. Copies of relevant APA/tax rulings

1. c. Industry Analysis

1. i. Major competitors
2. ii. SWOT analysis
3. iii. Power of suppliers
4. iv. Power of buyers
5. v. Availability of substitutes
6. vi. Size
7. vii. Demand and supply trends
8. viii. Entry requirements
9. ix. Key international target markets
10. x. Market share
11. xi. Modes of delivery

2. d. Financial Information including:

1. i. Annual financial statements
2. ii. Schedules applying the transfer pricing method
3. iii. Schedules for comparability analysis

10. CbC Reporting Template

This Appendix simply inserts the OECD Country-by-Country Reporting Templates (Tables 1–3).

11. User Manual for the Transfer Pricing and CbCR Form

This Appendix is a helpful step-by-step walk-through of:

1. the CbC notification and CbC report filing process;
2. the transfer pricing disclosure form that is now part of corporate income tax returns.

There are screen prints of the associated online pages to help anyone responsible for making these filings.

12. Example for Intangibles (1)

Company A and Company B are in different locations but part of the same MNE group. The companies are developing an intangible asset. The example argues that legal and contractual arrangements form the starting point for any transfer pricing analysis for intangibles and under the development agreement:

1. Company B will perform R&D under management and control of Company A;
2. Company A controls all Development, Enhancement, Maintenance, Protection, Exploitation (DEMPE);
3. Company A compensates Company B for R&D costs plus a mark-up;
4. Company A has the capacity and the control over the funding process;
5. Company A will be the legal owner of the intangible.

In this example, Company B performs routine functions and a routine reward is appropriate at arm's length.

13. Example for Intangibles (2)

Company A and Company B are in different locations but part of the same MNE group. The companies are developing an intangible asset based on Company B's existing intangibles, track record and experienced R&D staff. The intangible is expected to take five years to develop and then have a 10-year economic life. Under the development agreement:

1. Company B will perform and control all DEMPE activities;
2. Company A will provide all funding and will become the legal owner;
3. Company A has the capability and the capacity to provide the funding;
4. Company B will license the intangible from Company A and make contingent payments for the right to use the intangible.

The local tax administration for Company B undertakes a functional assessment which concludes that although Company A is the legal owner, its contribution is limited to that of a provider of finance. It is argued that Company A should just receive a risk adjusted return for providing finance with Company B earning the balance of all profits at arm's length.

14. Example for Intangibles (3)

The following example is provided:

1. Company A acquires 100% of the equity of Company Z (an independent person);
2. Company Z engages in R&D and has developed several promising technologies but has minimal sales;
3. Immediately after acquisition, Company A directs Company Z to transfer all intangible asset rights to Company S (a subsidiary of Company A);
4. Company S enters into an exclusive contract research arrangement with Company Z;
5. Company Z receives a routine cost plus mark up on R&D costs incurred;
6. Company S will fund all research and assume financial risk;
7. Company S undertakes full management, direction, control of Company Z activities;
8. Company S approves all new projects and budgets.

The Appendix asserts that the third-party price paid for Company Z is an important factor in ascertaining the value of intangibles in Company Z and that Company Z will require an arm's-length remuneration for the transfer of any intangibles. The Appendix argues that value does not disappear, nor is it destroyed by a business restructuring.

15. Business Restructuring—Risk

The following example is provided:

1. prior to a business restructuring, a distributor contractually assumes bad debt risk;
2. however, decisions about credit terms/recovery were taken by a related person (not the distributor);
3. the related person reimbursed the distributor for irrecoverable debts;
4. the related person is the only entity with the financial capacity to assume the risk.

In the above example, there is no transfer of credit risk as the distributor did not assume that risk prior to the restructuring.

The example also provides a consideration of inventory risk; in particular where the profile of a distributor is changed to one of lower risk, it is important to assess whether the reduction is significant by reference to:

1. role of inventory in the business model (e.g. speed to market);
2. nature of the inventory;
3. level of investment;
4. factors giving rise to obsolescence;
5. insurance and history of damage/loss.

16. Business Restructuring—Distributors

The following example is provided:

1. a distributor is operating under a long-term contractual arrangement;
2. it has the option to realistically accept or reject being converted into a limited risk distributor;
3. a restructuring leads to a renegotiation of contractual arrangements but no transfer of assets other than contractual rights.

There will need to be an assessment of whether the distributor is financially better off post restructuring, otherwise a compensation payment may be due at arm's length. It is argued that historic profits may not reflect future profits if the restructure has changed the model and it will be important to compare any forgone profits to other benefits (e.g. stability of profits going forward and less volatility).

In Summary

The Appendices to the 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 a number of helpful examples that will cover many real-life scenarios and help to shape transfer pricing policy and the associated documentation.

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 and Appendices provide a helpful framework for MNEs to construct robust documentation to minimize disputes and to agree tax rulings with GAZT to clarify key areas.

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Topics

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