Transfer Pricing Alert

12 December 2018

Saudi Arabia

Draft Transfer Pricing Bylaws issued for public comments

Introduction

On 10 December 2018, the General Authority of Zakat and Tax (‘GAZT’) of the Kingdom of Saudi Arabia (‘KSA’) issued a draft of the transfer pricing bylaws (‘Draft TP bylaws’ or ‘bylaws’) for public consultation (comments may be provided till 9 January 2019). The bylaws can be accessed here. Given KSA’s status as a G20 member that has fully endorsed OECD’s BEPS proposals, it was expected that KSA would issue transfer pricing guidelines in line with OECD’s recommendations on TP principles and documentation.

The bylaws contain provisions relating to TP methods, arm’s length principles, TP documentation requirements including maintenance of master file, local file and country-by-country report and audit procedures. Key aspects of the same are discussed below.

Recap of the current TP related provisions in KSA

Even though there are currently no specific TP rules or documentation requirements, Article 61 of the KSA income tax law provides that the tax department may request “any information related to tax” and Article 63 contains wide-ranging general anti-avoidance measures that provide the tax department with various discretionary powers if it believes that transaction is not bona fide or it has been structured in a way to reduce the impact of tax.

For the purpose of tax determination, the tax department may:

a) Disregard any transaction with no tax effect; or

b) Re-classify transaction whose substance and condition do not reflect its real form; or

c) Disallow deduction of a loss arising from transfer of properties between the taxpayer and a related party, until such time the related party disposes of the property to an unrelated party; or

d) Re-allocate the revenue and expenses of the transactions among related parties or parties under the same body so that this will reflect the revenue that would have resulted if the parties were independent and unrelated; or

e) Adjust the tax base of the taxpayer and that of the other person to prevent any reduction in the tax due.

While Oman, Kuwait and Qatar also have a requirement for transactions between related parties to be at arm's length, KSA has become the first GCC country to take a step towards issuance of detailed three-tiered documentation requirements and transfer pricing provisions for conformation to arm's length standard[1].

Key aspects of the draft TP bylaws

Effective date

The TP bylaws shall be effective from date of their official publication. The provisions, including those relating to maintaining documentation, shall come into force and have effect from 31 December 2018. These provisions will be applicable for the controlled transactions carried out during the fiscal year ended 31 December 2018 and onwards.

Applicability

The TP bylaws shall be applicable to all taxpayers (including Permanent Establishments) under the KSA income tax law and implementing regulations, who have entered into controlled transactions i.e. transactions involving Related Persons or Persons under Common Control (defined under the bylaws).

Arm's length principle

The definition of the arm's length principle is consistent with the OECD guidelines. In case the taxpayers enter into controlled transactions which are not at arm's length, they shall be required to make adjustments to their tax base and report such adjustments in their tax declarations.

In cases where the transactions are not at arm's length, the GAZT may make adjustment to the tax base or reallocate and recategorize revenue and expenses arising out of the controlled transactions. Also, in eligible cases, the bylaws comprise provisions regarding the manner of seeking corresponding adjustments where adjustments have been made in other countries.

Approved transfer pricing methods and comparability

The following five transfer pricing methods, in no particular order of preference, have been prescribed in line with the OECD TP methods:

1. Comparable Uncontrolled Price Method
2. Resale Price Method
3. Cost Plus Method

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[1] *While Qatar has recently issued CbC legislation, it does not have detailed TP provisions in respect of Master File, Local file and the procedure for transfer pricing analysis.*

4. Transactional Net Margin Method
5. Transactional Profit Split Method

The most appropriate method from the above methods should be selected for the determination of arm's length results. The bylaws also provide for use of any other method if none of the above methods provides a reliable measure for arm's length results and satisfies the considerations for selection of the most appropriate method.

The bylaws provide for applicability of arm's length range (statistical range to be notified later), preferred use of only one method, and restriction on the use of secret comparables by taxpayers as well as the tax authorities.

Compliance requirements and due dates

<table>
<tr><th>Particulars</th><th>Contents</th><th>Applicable to</th><th>Due Date</th></tr>
<tr><td>Disclosure Form of Controlled Transactions ('DFCT')</td><td>Specified information regarding controlled transactions</td><td>All taxable persons required to file annual income tax return</td><td>120 days from end of fiscal year
(First due date: 30 April 2019)</td></tr>
<tr><td>Master File</td><td>Information on global business operations and TP policies - Broadly consistent with BEPS Action Plan 13 report</td><td rowspan="2">Taxable persons <u>except</u>:
a) Natural persons
b) Small size enterprises i.e. juridical persons with controlled transactions of total arm's length value not exceeding SAR 6 mn (approx. Eur 1.4 mn) in a 12-month period
c) Juridical persons with no controlled transactions
(Also, Refer Note 1 below)</td><td>Confirmation of maintenance to be given in DFCT
To be submitted on request by GAZT (within 30 days)</td></tr>
<tr><td>Local File</td><td>Information regarding taxpayer, TP analysis for controlled transactions, industry analysis and financial information - Broadly consistent with BEPS Action Plan 13 report</td><td>Confirmation of maintenance to be given in DFCT
To be submitted on request by GAZT (7 to 30 days)</td></tr>
<tr><td rowspan="2">Country-by-Country ('CbC') Report</td><td>CbC report comprising information on entities within the MNE - Broadly consistent with BEPS Action Plan 13 report</td><td rowspan="2">CbC report is to be filed by a KSA income tax payer being an Ultimate Parent Entity ('UPE')/ constituent entity/ designated entity (as the case may be) that is member of an MNE group[2]

Notification is to be submitted by a KSA income tax payer being a constituent entity of an MNE group[2] (other than the above) in cases where CbC report is filed by another group entity[3]</td><td>12 months after end of reporting year
(First due date: 31 December 2019)</td></tr>
<tr><td>Notification regarding identity and residence of the CbC reporting entity</td><td>120 days from end of reporting year
(First due date:
30 April 2019)</td></tr>
</table>

[2] having consolidated group revenue exceeding SAR 3.2 billion (approx. Eur 750 mn)

[3] If the CbC report is filed outside KSA, then notification may be submitted only where KSA has an underlying information exchange mechanism in place, otherwise a detailed CbC report will need to be filed by the KSA constituent entity.

Note 1:

The exceptions regarding maintenance of Master File and Local File would not apply if:

a) Controlled transactions are carried out with persons which are**:**

- deemed to be residents of or established in a special economic zone in KSA; or
- legally granted any exemption or relief from tax/ zakat/ both in KSA;

b) The GAZT believes that any of the circumstances for tax-avoidance as detailed in Article 63 exists; or

c) A corresponding adjustment has been sought by the taxpayer.

Audit procedures

The bylaws provide that the GAZT shall follow the audit rules and procedures established under Article 62 of the KSA income tax law. Accordingly, transfer pricing audits are likely to form part of the overall tax audit procedure.

To eliminate economic double taxation under a mutual agreement procedure (as per a double tax avoidance agreement), in eligible cases, taxpayers can submit an application to the GAZT for a corresponding adjustment where adjustments have been made in respect of controlled transactions in other countries.

Key observations/ open issues

We have set out below, some of our key observations on the draft bylaws and some open issues which would need more clarity.

Particulars	Article reference	Observations/ Open Issues
Extent of coverage of the TP bylaws	Article 1 and 2	• TP provisions seem to apply to transactions between domestic related persons as well (KSA residents). There is no requirement for a "Controlled transaction" to be with a non-resident person for applicability of TP bylaws. Clarity on this in the final bylaws would be helpful. • Additionally, it appears that the TP provisions apply to all taxable persons under the KSA income tax law. This taxpayer base does not expressly include corporations which pay only Zakat. More clarity would be required from the GAZT in this regard. Also, clarification on how thresholds/ other provisions of these bylaws would apply to companies which pay Zakat as well as income tax would be helpful.
Compliance requirements – DFCT	Article 4 and 14	• Since the due date of filing the first DFCT for fiscal year ended 31 December 2018 is 30 April 2019, covered taxpayers will need to start preparing TP documentation immediately and conclude whether their controlled transactions are at arm's length or not. In cases, where it is determined that these are not at arm's length, adjustments to taxable income would be required in the income tax returns. Taxpayers have less than 140 days from today to complete this.

Particulars	Article reference	Observations/ Open Issues
Considerations for small enterprises	Article 2, 14 and 19	• Generally, thresholds for determination of applicability of transfer pricing provisions are set by countries with reference to the value of controlled transactions. However, under the KSA draft TP bylaws, the threshold for qualifying as a small enterprise has been given as the **arm's length value** of controlled transactions (being lower than SAR 6 mn in a 12-month period) instead of the transaction value. This would require such persons also to undertake a benchmarking analysis to determine whether the arm's length value of controlled transactions is below specified limits. • In addition to the above, the DFCT (which small enterprises are not exempted from) also requires taxpayers to mention "Transfer Pricing method applied in accordance with Chapter 4 of the Bylaws". Thus, while preparation of Master File and Local File will not be required by small enterprises, they would need to undertake a transfer pricing analysis including benchmarking study to be able to provide correct information in the DFCT regarding the TP method used.
Definition of 'Related Persons', 'Persons under Common Control' and 'Effective Control'	Article 1	• The coverage of transactions under TP provisions would need to be assessed in detail considering the elaborate definitions in the bylaws.
Language of TP documentation	-	• The bylaws do not mention the language in which documentation is to be maintained and filed. Currently, income tax returns are filed in Arabic and all correspondence with the GAZT is required to be in Arabic. Clarification on the language for maintenance of TP documentation is awaited.
Welcome provisions in the bylaws	-	• In certain areas, much-needed flexibility has been provided to taxpayers in the bylaws for instance, providing for use of arm's length range, aggregation of transactions for TP analysis in case they are closely related, use of any other method apart from the five OECD methods, advocating use of a single method for benchmarking, use of foreign comparables etc.
Others	-	• The bylaws are broadly consistent with international standards and with BEPS Action Plan 13 recommendations. • No provisions regarding penalties for non-compliance by the specified due dates or for cases where it is determined that the transactions are not at arm's length. • No advance pricing arrangements provision which is a route that is increasingly being adopted by many MNE taxpayers to obtain certainty in respect of their tax and transfer pricing positions. • KSA, being a G20 country, has committed to follow the OECD's BEPS measures in entirety and accordingly, the tax authorities are likely to follow guidance in the reports on Actions 8-10 while assessing transactions in relation to intangibles and intra-group services.

One would need to wait for the Guidelines referred to in the bylaws which would provide further information and details related to these bylaws.

What next for KSA headquartered businesses/ MNEs having presence in KSA

One of the key aspects of managing transfer pricing risks would be to undertake a holistic review of TP arrangements/ documents as on date. Following are some of the key considerations/ action points for taxpayers in the KSA:

- Analysis of the extent of applicability of bylaws to controlled transactions, specifically the following:
  - Determination of whether the taxpayer qualifies as a "small enterprise" and accordingly be exempt from maintaining a detailed Master File and Local File as prescribed;
  - Review of arrangements like loans/ guarantees/ exclusivity contracts etc. which could meet "effective control" criteria requiring adherence to transfer pricing principles even in the absence of a direct/ indirect control;
- Review of existing documentation, if any, to demonstrate arm's length pricing of controlled transactions and whether it would meet the following requirements under the bylaws:
  - Whether the selected comparables meet the comparability factors viz. the characteristics of property or services transferred, functions, assets and risks undertaken, contractual terms, economic circumstances etc. and can be made available to the tax authority on request;
  - Whether any comparability adjustments made to support transfer prices are reasonably accurate;
  - Whether arm's length range used, if any, is consistent with the provisions (Guidelines would specify the details);
  - Whether the transfer pricing method selected is the most appropriate method and also, considering the circumstances, whether any other method would be more suitable;
  - Whether any adjustments will be required to the income tax base of the taxpayer in case of transactions not being at arm's length; and
- Preparation/ collation of additional documentation to bridge any gaps in the existing documentation; and
- Collation of requisite information from all group entities for Master file and CbC report specially where the KSA taxpayer is required to maintain/ file such documents in KSA and is a part of an MNE group which is not maintaining the same

Contact us

While this Alert summarises the key aspects of the draft TP bylaws, if you would like our assistance in understanding the specific implications of the transfer pricing laws to your business, planning ahead from a litigation risk mitigation perspective and undertaking requisite compliances, please feel free to get in touch with us at nilesh.ashar@dhruvaadvisors.com or vartika.jain@dhruvaadvisors.com.

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