Transfer Pricing Update

INSIGHTS INTO THE DRAFT TRANSFER PRICING REGULATIONS OF SAUDI ARABIA

JANUARY 2019

BDO Tax Alert

Insights into the draft Transfer Pricing Bylaws issued by The General Authority for Zakat and Tax, Saudi Arabia

The General Authority for Zakat and Tax, Saudi Arabia ("GAZT") published the Draft Transfer Pricing Bylaws ("TP Bylaws") on 10 December 2018 for public consideration.
After receiving feedback from the public, the GAZT will incorporate any necessary changes and will publish the finalised Bylaws.

Background

Transfer Pricing ("TP") as a concept was initially incorporated in the Royal Decree No. (M/1) dated 15/1/1425H and related amendments ("Saudi Corporate Tax Laws"), although in a very brief and basic manner. The issuance of the TP Bylaws is in line with Saudi Arabia's commitment, as a member of the Inclusive Framework, to implement the four minimum standards of the Base Erosion and Profit Shifting ("BEPS") project of the Organisation for Economic Co-operation and Development ("OECD").

The TP Bylaws, in a nutshell, provide a framework to ensure that controlled transactions entered into between related persons are at Arm's Length. They lay down the acceptable methods to determine and establish the Arm's Length nature of transactions, related documentation to be maintained and submitted with GAZT as well as other machinery provisions to ensure compliance. The draft TP Bylaws of Saudi Arabia are closely aligned with the OECD Transfer Pricing guidelines.

Broadly, entities part of multinational group operating in Saudi Arabia will be required to meet TP compliance obligations including a requirement to certify to GAZT annually on the existence and details of Controlled Transactions (e.g. related party transactions -see definitions section of this document) as well as maintaining certain documentation of their local and global business, as may be applicable.

In this edition, we have dissected the operative portions of the TP Bylaws and have endeavoured to highlight its most important elements.

Applicability

- The TP Bylaws are applicable to taxpayers under the Saudi Corporate Tax Law ("Taxable Persons"). This will cover within its ambit most foreign companies doing business in Saudi Arabia, including Permanent Establishments ("PE").
- Does not exclude any domestic transaction between two related ***taxable*** persons.
- Generally, the TP Bylaws will not apply to Saudi companies wholly owned by Saudi nationals.

Effective dates

- The TP Bylaws shall take effect from the date of its future publication in the official gazette.
- Provisions relating to maintaining documentation (Chapter 8) shall come into force as of 31 December 2018.
- The TP Bylaws will be applicable to "Controlled Transactions" undertaken by "Taxable Persons" during the fiscal year ending 31 December 2018.

Three tier documentation

In line with the recommendations of the OECD, the following documents are required to be prepared by Taxable Persons, as may be applicable:

- Master file.
- Local File.
- Country by Country Report ("CbCR"), if applicable.

Annual compliance obligations

1. Disclosure Form to be filed along with the annual income tax return within 120 days of the end of the financial year, containing information related to Controlled Transactions.
2. Master File to be maintained and submitted within 30 days of the GAZT making the request.
3. Local File to be maintained and submitted within 7 days of the GAZT making the request.

4. Notification of CbCR to be filed within 120 days following the end of the reporting year.

5. CbCR to be filed within 12 months from the end of the reporting year (applicable if consolidated group revenue exceeds SAR 3.2 Billion (approx. 853 million USD).

Conditions for CbCR:

- To be filed by Ultimate Parent Entity ("UPE"), if a Saudi entity;

- If the UPE is not a Saudi Entity, the Constituent Entity ("CE") [i.e. the tax payer] is obligated to file CbCR, if:
  - The CE is a taxable person; **and**
  - UPE is not obligated to file a CbCR in its country of tax residence; or
  - The UPE is a tax resident of a jurisdiction that does not have a Qualifying Competent Authority Agreement to which Saudi is a party; or
  - The UPE is in a tax resident of a jurisdiction that has a Qualifying Competent Authority Agreement to which Saudi is a party but has suspended automatic exchange of information

Exemptions from documentation

- Natural persons
- Small Size Enterprises (total Arm's Length value of related party transactions ("Controlled Transactions") does not exceed SAR 6 million). This is a good relief for small start-up businesses in Saudi Arabia.
- Corporates not entering into "Controlled Transactions"
- GAZT, however, reserves the right to direct any person to prepare, maintain and submit any documentation at its discretion

  It appears that even exempt Taxable Persons are required to file the Disclosure Form annually containing information relating to Controlled Transactions.

Snapshot of information required to be maintained and submitted

- <u>**Content of Disclosure Form**</u>

An annual Disclosure Form is required to be submitted along with the income tax return of a taxable person, containing the following:

a. Information about the Related Person (s) to the Controlled Transactions (including names, and countries of residence and establishment)
b. Information about any business restructuring for the Multi National enterprise Group ("MNE Group") or Taxable Person
c. Legal and beneficial owners of the Taxable Person
d. Total revenue, expenses and net profit (loss)
e. Type and nature of the relationship between the Related Persons to the Controlled Transaction
f. Nature of the business activities of the Related Persons
g. Financial information such as aggregate amounts of consideration, nature of income / expenses
h. TP method applied.
i. A statement certifying whether or not the Taxable Person has entered into any Controlled Transaction or any Transaction without consideration or non-monetary consideration.
j. Whether the TP documentation are maintained such as Master File and Local File.

Separately, a Taxable Person with total Arm's Length value of Controlled Transactions that exceed SAR 6 million is required to prepare and make available upon request, the following documents:

1. Master file
2. Local File

- <u>**Content of the Master File**</u>

Master File on the global business operations of the Multinational Group to which the Taxable Person belongs should include information such as the following:

a. Group structure
b. Description of the Group business
c. Intangibles of the Group
d. Intercompany financing arrangements
e. Financial and tax position of the Group

- <u>**Content of the Local File**</u>

The Local File should contain information such as the following:

a. Information of the Taxable Person such as organizational chart, business strategy etc.
b. Documentation on material Controlled Transactions

c. Analysis of the industry of the Taxable Person
d. Financial information

- **Content of Country by Country Report**

A Taxable Person with consolidated group revenue exceeding SAR 3.2 Billion (approx.USD 853 million) is required to meet the CbCR requirement. The information required under the KSA CbCR is similar to the OECD guidelines and should include the following:

I. Financial information including the following:

a. Aggregate value of revenue, profit (loss) before income tax and income tax paid and accrued,
b. Stated capital and accumulated earnings;
c. Number of employees; and
d. Details of tangible assets other than cash or cash equivalents

II. For each CE of the group, the CbCR must include details of the country of tax residence, and nature of the main business activities of such member entity.

Approved TP methods

For the purpose of determining the Arm's Length Results of a transaction and in line with the OECD TP guidelines, the TP Bylaws set out the following approved TP methods:

1. Comparable Uncontrolled Price Method;
2. Resale Price Method;
3. Cost Plus Method;
4. Transactional Net Margin Method; and
5. Transactional Profit Split Method

The TP Bylaws do not specify any preference for the order in which the methods should be used. The TP Bylaws permits Taxable Persons to apply a TP method other than the above Approved Methods provided certain conditions are met.

As per Chapter 4 of the TP Bylaws, the most appropriate TP method should be used after taking into consideration the following criteria:

1. The respective strengths and weakness of the approved methods;
2. The appropriateness of an approved method determined in particular through an analysis of the functions undertaken by each person in Controlled Transactions;
3. The availability of reliable information; and
4. The degree of comparability between Controlled and Uncontrolled Transactions.

Key Definitions

Broad definitions with far reaching implications

1. Controlled Transactions

Any transaction involving ***related persons*** or ***persons under common control***. The meaning of term also includes notional transactions or consideration exchanged between a person and its permanent establishment, to the extent that such transactions are recognised for the purposes of the Saudi Corporate Tax Laws.

2. Related Persons

a. Natural persons

- Married or relatives to the fourth degree; or
- Partners in a partnership

b. Natural person and Juridical person

- Partner or a shareholder and either alone or jointly with a related person directly or indirectly controls 50% or more of the voting rights, income, capital of the partnership firm or the Company
- The beneficiary or intended beneficiary of a trust, either alone or with a related person
- If the person alone or jointly with a related person directly or indirectly participates or is able to participate in the management, control or capital of a juridical person

c. Juridical persons

- They become related parties if they are Persons under ***common control***
- A person who controls or has the ability to control the business of a juridical person has, together with a ***Related person***, ***Effective Control*** of the other juridical person
- The same group of persons have ***Effective Control*** over both juridical persons
- Two ***Related Persons*** having ***Effective Control*** over two juridical persons separately
- Juridical person participated directly or indirectly in the management, control or capital of the other or otherwise has ***Effective Control*** of the other

3. Persons under common control

Two or more juridical persons are deemed persons under common control if either:

- The person or related persons, individually or jointly, control directly or indirectly 50% or more of such persons; or

[Control is defined to mean actual ownership, right to use and dispose-off as owner, or ability to own with reasonable certainty the rights to a Partnership's income or capital or a Company's voting rights or capital or income]

- The person or related persons, either separately or jointly, directly or indirectly, are able to control the business decisions of such juridical person or have **Effective Control** over such juridical person.

4. Effective control

Effective control is the ability of a person to control the business decision of another person.

Following are the scenarios, *inter alia*, wherein a control relationship would be triggered and a person can be deemed to have effective control over the other:

- Ability to conclude an agreement to provide management services to the company or otherwise effectively perform functions of management for the other person
- Ability to act as a trustee of the other person
- Ability to control the composition of 50% or more of the Board or appoint or dismiss management representatives
- Legal or *De facto* right to receive 50% or more of profits of the other person
- Outstanding loans of 50% or more of the funds necessary for the business of the other person
- Guarantees to cover 25% or more of the total borrowings
- 50% or more of a person's business depends on transactions with such other person
- Direct or indirect holding of 50% or more or participation in the management of the juridical person
- Principle supplier of the other person under an exclusive agency, distribution and similar arrangement
- A substantial portion of the business activities of a resident person depends on transactions with a non-resident person *and* the resident's business activities depend on rights in intangible property granted exclusively to the resident person
- Controlling the business decisions of the other person in any other way as evidenced by facts and circumstances.

Under the broad ambit of the term "Effective Control", there are scenarios wherein transactions between non-related parties could also be classified as controlled transactions.

Penal provisions

Specific penal provisions not included in the TP Bylaws. However, penal implications could be incorporated into the law by the GAZT at a later stage.

What are taxpayers required to do

- Conduct an initial impact assessment to determine the applicability and impact of the TP Bylaws.
- Understand the requirements under the TP Bylaws.
- Identify Controlled Transactions.
- If applicable, extract information and prepare documentation (master file, local file and CbCR) as required by the TP Bylaws for the fiscal year ending 31 December 2018.
- Establish an internal TP framework / include Saudi business in existing TP framework to ensure compliance 2019 onwards.
- **Immediate action point will be to prepare for transaction data for the fiscal year ending 31 December 2018 required to be submitted through the "Disclosure Form", at the latest by 30 April 2019.**

A few matters that need attention

- While the concept of adjustments have been allowed in case of diverging conditions, the scope and definition of acceptable adjustments have not been included.

- Adjustments for comparable transactions (e.g: adjustment for working capital, risk etc.) can be made but the acceptable mechanism for making these adjustments have not been prescribed.

- To qualify as an exempt small enterprise, it appears as if a benchmarking analysis will anyway be required to be undertaken as per the definition of Small Enterprises to determine the Arm's Length Value of controlled transactions. This increases compliance burden for small businesses.

- The process of selection or rejection of comparable companies has not been provided. This may lead to cherry picking of comparable companies, both by the taxpayer and by the GAZT. The TP Bylaws, however, prohibit the use of secret comparables.

- While there are exemptions for certain persons to not maintain TP records, the GAZT has reserved the right to direct any person to maintain any documentation and call for it anytime it deems fit.

- The possibility or prohibition for using non-contemporaneous data has not been considered.

- The term "substantial" is not defined in the context of Effective Control and could, therefore, lead to myriad interpretations.

- Time limit to commence and complete TP audits by GAZT not provided.

Our comments

The issuance of the draft TP Bylaws is a welcome step by the GAZT and displays Saudi Arabia's efforts to meet its commitment of being part of the Inclusive Framework to implement BEPS measures. The TP Bylaws are mostly in line with the principles laid down by the OECD.
is one of the most litigated tax issues globally, especially in countries where TP as a concept is at a nascent stage. While the introduction of a formal TP law is an economically progressive step taken by the Kingdom it will, no doubt, come with associated issues - some that will be resolved with experience and some through litigation.

The timeframes given to businesses to prepare for such revolutionary tax changes are rather short. However, multinationals operating in jurisdictions that have TP requirements will be able to leverage some of their existing TP study and analysis for their obligations in Saudi Arabia, especially given that the TP regulations of Saudi Arabia are closely aligned with the OECD TP guidelines.

With the introduction of TP in Saudi Arabia, we expect more foreign companies to re-examine how their business arrangements are structured in order to determine whether a PE exists in Saudi and / or the applicability of the TP Bylaws.

Summary

For the sake of convenience, we have provided below a summary providing a snapshot of the most relevant details regarding the applicability of the TP regime.

Sl No	Important milestones	Legislative direction
1	Date of applicability of TP Bylaws	From the date of future publication in the Official Gazette
2	Date of applicability of provisions for maintaining documentation	December 31, 2018
3	First compliance requirement to be met by taxpayers - filing the Disclosure Form (for the fiscal year ending 31 December 2018)	April 30, 2019
4	CbCR Notification, if applicable (for the fiscal year ending 31 December 2018)	April 30, 2019
5	CBCR filing, if applicable (for the fiscal year ending 31 December 2018)	December 31, 2019
6	Documentation to be maintained by taxpayers (unless exemptions apply)	- Master File - Local File - CbCR
7	Exceptions to maintain documentation	- Natural persons - Small Size Enterprises (total Arm's Length value of transactions does not exceed SAR 6 million - Corporates not entering into "Controlled Transactions"
8	When the GAZT calls for documentation relating to controlled transactions or Master File	To be submitted no later than 30 days after the date of such request
9	When the GAZT calls for Local file	To be submitted no later than 7 days after the date of GAZT request

WHY BDO?

Experienced global team

BDO is amongst the largest global professional firms with accessible transfer pricing professionals worldwide. This places BDO in a position to provide transfer pricing support to our clients wherever their business takes them.

Exceptional client service

At BDO, our experienced professionals adopt a hands-on approach in delivering transfer pricing and value chain solutions. This enables BDO to:

- Understand our clients' priorities
- Provide senior level contact to address client concerns
- Address key issues proactively and efficiently

BDO takes a phased approach to managing transfer pricing projects to maximise efficiency and transparency of our engagement.

Practical solutions

We pride ourselves on our ability to work with our clients to develop creative, practical and robust transfer pricing solutions that are 'fit for purpose.' However simple or complex the solutions, we provide pragmatic, practical and clear advice that identifies any tax risks and opportunities to better enable our clients to make informed transfer pricing decisions.
At BDO, the people working with you will be directly overseeing the analysis supporting your transfer pricing. This is essential given local legislation in many jurisdictions is based on the OECD Transfer Pricing Guidelines which have heightened the emphasis placed on the importance of identifying quality third party comparables.

Scalable support

We are able to deliver transfer pricing and value chain projects on a scale tailored to our clients' needs. This ranges from delivering the entire global project, to situations where we work with in-house tax and transfer pricing teams to deliver more discrete support.

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How BDO can help

At BDO, our experienced transfer pricing professionals adopt a hands-on approach with clients in delivering comprehensive TP solutions.

Our team can assist you with the following:

- Conducting an initial impact assessment
- Reviewing business arrangements and related party transactions from a TP perspective
- Assisting with the selection of approved TP methods
- Assisting with TP policy
- TP implementation
- Assisting with TP documentation
- TP advisory services
- Assisting with TP audit
- Training

Contact us for a discussion

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