Saudi Arabia Transfer Pricing Bylaws: Key Questions Answered

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The transfer pricing regulations now effective in Saudi Arabia are a significant tax development and introduce new compliance requirements related to transfer pricing documentation and Country-by-Country ('CbC') reporting.

Following the publication of the draft transfer pricing bylaws for public consultation in December 2018, the General Authority of Zakat and Tax ('GAZT') of the Kingdom of Saudi Arabia ('KSA') issued the final Transfer Pricing Bylaws ('TP Bylaws') in February 2019.

The final TP Bylaws are broadly in line with Organization for Economic Co-operation and Development ('OECD') TP Guidelines and do not contain any major surprises. However, there were a few changes to the draft TP bylaws that were published for consultation.

The key changes were additional clarification on areas where there was some uncertainty such as the application of the TP Bylaws to pure zakat paying entities (N.B.: entities which are wholly owned by Saudi or GCC nationals are subject to zakat rather than income tax), an extension of the period for submission of the local file and the introduction of a requirement to obtain an affidavit from a licensed auditor.

Why Were the Bylaws Introduced?

The OECD initiated a project at the request of the G-20 to prevent base erosion and profit shifting ('BEPS'), tackle international tax avoidance and increase tax transparency and information exchange. As part of the BEPS project, the OECD developed a 15-point BEPS action plan and established a BEPS inclusive framework ('BEPS IF') under which signatories committed to implement four minimum standards of the BEPS action plan.

As a signatory to the BEPS IF, the KSA has agreed to implement the four minimum standards. The BEPS minimum standards include the OECD recommendations related to Action 13 of the BEPS Action Plan on transfer pricing documentation and CbC reporting. The KSA introduced TP Bylaws as part of its commitment as a member of the BEPS IF.

The TP Bylaws will also enable the KSA to bring its tax rules in line with international standards and will provide the GAZT with additional tools to protect the KSA's tax base and prevent companies from using related party transactions to artificially shift profits from the KSA to other countries with lower tax rates or no taxes.

When Do They Apply?

The TP Bylaws apply to the reporting year ending on December 31, 2018 and all subsequent reporting years.

What is the Impact?

Under the current KSA tax law, companies that are subject to KSA tax are already required to conduct related party transactions on an arm's length basis. In addition, KSA companies are required to maintain documentation to support the tax payable. However, there was no specific requirement to have transfer pricing documentation in place.

Previously, the GAZT relied on the provisions of the tax law to make any transfer pricing adjustments and there was no requirement to separately disclose related party transactions. Going forward, the GAZT will have more tools available to it and will be better able to scrutinise related party transactions.

Companies that are taxable in the KSA will now need to comply with additional requirements in the TP Bylaws, including disclosure obligations and preparation of master file and local file documentation and CbC reporting.

Scope of the TP Bylaws

The TP Bylaws apply to to all taxpayers in the KSA, including:

- companies that are wholly owned by non-Gulf Cooperation Council ('GCC') nationals (member states are the KSA, Kuwait, the United Arab Emirates, Qatar, Bahrain and Oman) and fully subject to income tax;
- companies with both GCC and non-GCC ownership that are subject to both tax and zakat; and
- permanent establishments of non-residents in the KSA.

The TP Bylaws will not apply to entities that are fully subject to zakat except where they will be required to comply with the CbC reporting requirements.

It is important to note that unless exempt by the TP Bylaws all related party transactions where there is a KSA taxpayer are within the scope of the TP Bylaws, regardless of the place of residence, nationality or domicile of the persons.

As such, the TP Bylaws apply to international transactions as well as domestic transactions, including transactions between taxpayers and entities that are fully subject to zakat.

Main Provisions

Arm's Length Principle

The 'arm's length' standard is based on the OECD Guidelines and requires transactions between two or more related parties to be conducted on terms that would be applied had the parties been independent.

Definition of Related Party

The definition of related parties is very wide and potentially captures the relationship between two or more natural persons as well as the relationship between a natural person and a legal person. Two or more legal persons may also be related parties where they are under common control.

The concept of 'effective control' is also introduced, whereby a person can control the business decisions of another person, directly or indirectly, by way of a management agreement, a trust arrangement or control over 50 percent or more of the composition of the board of directors.

The definition of 'effective control' also extends to control exercised via a debt and equity relationship including through the right to receive 50 percent or more of the profits of the other person, the provision of a loan representing 50 percent or more of the debt and capital (excluding retained earnings) of the other person, and the provision of a guarantee to cover 25 percent or more of the other person's total borrowings.

Finally, 'effective control' also applies to control via a business relationship and is deemed to exist where 50 percent or more of the aggregate value of transactions is with a single customer and where there is an exclusive agency or distributorship relationship.

Arm's Length Range

The TP Bylaws state that the arm's length range is a range of acceptable results such as prices, margins or profit shares produced by applying the most appropriate transfer pricing method. However, there is no guidance in the TP Bylaws on how to determine the arm's length range.

The GAZT have confirmed that where there is a range of results the interquartile range is an acceptable approach to determine an arm's length range.

Approved Methods

The TP Bylaws set out approved transfer pricing methods to determine an arm's length result which are based on the OECD TP Guidelines. The approved transfer pricing methods are:

- comparable uncontrolled price method;
- resale price method;
- cost plus method;
- transactional net margin method; and
- transactional profit split method.

However, taxpayers may apply another transfer pricing method where they are able to demonstrate that none of these methods provides a reliable measure of an arm's length result.

All taxpayers will have to adopt one of the approved methods or otherwise justify why these methods are not appropriate and another method should be applied.

Transfer Pricing Adjustments

The taxpayer is required to make an adjustment to the tax base if the transactions are not conducted on an arm's length basis. The GAZT may also require the taxpayer to adjust the tax base or reallocate revenue and expenses and disregard related party transactions in accordance with an arm's length outcome.

Key Compliance Obligations

The TP Bylaws introduce new compliance requirements that affect all taxpayers in the KSA. The key obligations are set out below.

Disclosure Requirement

All taxpayers with related party transactions will be required to submit to the GAZT, along with their annual income tax return, a disclosure form that includes details of their related party transactions, irrespective of the value of the transactions.

The disclosure is required to be made with the tax return within 120 days of the fiscal year end. For companies with a financial year ending on 31 December 2018, the first disclosure was required by 30 April 2019.

The disclosure must include an affidavit from a licensed auditor in the KSA certifying the consistent application of the transfer pricing policy by the taxpayer. While it is not clear precisely what this will involve in practice, in our view it does not mean that the auditor is required to confirm that the related party transactions are arm's length.

Master File and Local File

Taxpayers with related party transactions of an annual value above six million Saudi Arabian riyal ($1.6 million) are required to prepare and maintain a master file containing information on the global business operations and transfer pricing policies of the group and a local file containing detailed information on all controlled transactions. Pure zakat paying entities are exempt from the requirement to prepare a master file and local file.

There is no deadline by which the master file and local file are required; however, they may be requested by the GAZT any time up to 120 days after the fiscal year end and must be submitted to the GAZT within 30 days of the request (under the draft TP bylaws the local file was required to be submitted within seven days of the GAZT's request but the final TP Bylaws extended this period to 30 days).
For the calendar year 2019, the GAZT will give all taxpayers an extension of 60 days to submit the master file and local file.

Country-by-Country Reporting

Taxpayers and fully zakat paying entities that are part of a multinational enterprise ('MNE') group and have consolidated group revenue exceeding 3.2 billion Saudi Arabian riyal are required to submit a CbC report within 12 months from the MNE's year end, and to notify the GAZT regarding the ultimate parent entity and the entity that submits the CbC report within 120 days of the end of the reporting year.

The CbC reporting notification and report is required to be submitted in the KSA by the ultimate parent entity or the surrogate parent entity of a MNE group in the KSA. A constituent entity that is not an ultimate parent or a surrogate parent of a MNE group must provide the notification and could file the CbC report in the KSA subject to certain conditions.

The CbC report will include information related to the aggregate value of revenue, profit (or loss) before tax, income tax paid, income tax accrued, stated capital, accumulated earnings and the number of employees.

Penalties for Non-compliance

No penalties have been specified in the TP Bylaws for any non-compliance with the requirements. However, the GAZT reserves the right to impose penalties under the current tax law and, accordingly, penalties may apply for any adjustments to the tax liability. It is also possible that specific penalties may be announced later by new legislation.

Do Other GCC Countries have Transfer Pricing Regimes?

While some other GCC countries, such as Qatar, Oman and Kuwait, have rules within their domestic tax laws which require related party transactions to be undertaken on arm’s length terms, these countries do not have a specific requirement to have transfer pricing documentation in place.

As the United Arab Emirates, Qatar, Bahrain and Oman are also members of the BEPS IF, the expectation is that these countries will introduce specific legislation to implement the OECD recommendations on transfer pricing and CbC reporting under Action 13 in due course.

Planning Points

The TP Bylaws are a significant development and introduce new compliance requirements related to transfer pricing documentation and CbC reporting.

As domestic transactions are within the scope of the TP Bylaws, it is important for taxpayers to maintain transfer pricing documentation to support the arm’s length nature of the transactions even with pure zakat paying entities where required.

The disclosure form was required to be submitted by 30 April 2019 for all taxpayers with a financial year end of 31 December 2018 where they have related party transactions regardless of their value. It will be a major challenge for such taxpayers to identify the related party transactions within the given timeframe.

Although there is an extension of the period after which the GAZT may request transfer pricing documentation for 2019, giving businesses additional time, in practice, the requirement for a licensed auditor to certify that the transfer pricing policy has been applied on a consistent basis may mean that taxpayers will need to have transfer pricing documentation by the time they submit their tax return in 2019.

All MNEs operating in the KSA, and other companies operating in the KSA, should assess the impact of the TP Bylaws on their businesses and understand their tax obligations.

Businesses that already have transfer pricing documentation in place for example, MNEs that may have maintained such documentation due to transfer pricing requirements in other countries, should review their existing documentation to ensure that it is compliant with the KSA TP Bylaws.

Other businesses should seek to review their inter-company transactions and undertake a functional and economic analysis to ensure that they are conducted on arm's length terms, and put in place transfer pricing documentation to support the pricing.

Al Tamimi & Company's Tax Team regularly advises on transfer pricing, corporate tax, VAT and other tax matters in the Middle East. For further information please contact Shiraz Khan (s.khan@tamimi.com).