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E-Invoicing: Beyond VAT, what about TP?

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Introduction

Over the last few years, we have witnessed governments in the Middle East (ME) region rapidly introduce a number of tax reform measures. The Transfer Pricing (TP) regulations were introduced in key jurisdictions like the Kingdom of Saudi Arabia (KSA), the State of Qatar (Qatar) and the Hashemite Kingdom of Jordan (Jordan) TP regulations have also been updated in the Arab Republic of Egypt.

Value Added Tax (VAT) was introduced and reformed in Egypt, the KSA, the United Arab Emirates (UAE), the Kingdom of Bahrain (Bahrain), Jordan and the Sultanate of Oman (Oman). While all the stakeholders, including tax administrations, taxpayers, and tax advisors, digest and adapt to these changes, there is another crucial change: The Electronic Invoicing (e-Invoicing) system.

In simple words, the e-Invoicing system is a procedure that aims to transform the manual process of issuing (paper) invoices into an electronic process that allows the exchange of invoices, debit and credit notes and processing of them in an organized electronic format between sellers and buyers.

However, is the e-Invoicing phenomenon currently being witnessed a pure VAT related issue or are there important TP considerations? Is there an impact of the transparency caused by e-Invoicing? In this article, we analyze the impact of e-Invoicing on TP related matters and some important points to be aware of while preparing for e-Invoicing. This article mainly focuses on KSA VAT, e-Invoicing and TP regulations introduced by the Zakat, Tax and Customs Authority or "ZATCA", with some references to other Middle East jurisdictions.

TP, VAT, and e-Invoicing: Where do we stand today?

Back in 2017, the Gulf Cooperation Council[1] (GCC) member states signed the VAT Framework Treaty, confirming the introduction of a VAT system in all member states. In line with this commitment, VAT was introduced in the UAE, KSA, Bahrain, and most recently Oman as well.

Around the same time, TP regulations were also introduced in some of the GCC member countries.

The following table provides a snapshot of the TP, VAT and e-Invoicing statuses in various Middle East countries:

Country	TP Regulations	VAT Regulations	e-Invoicing
Bahrain	Limited (only Country-by-Country Reporting "CbCR")	Yes	No - Detailed legislation published.
Egypt	Yes	Yes	Yes – Introduced e-Invoicing in Nov. 2020 for selected large taxpayers in a trial phase and is expected to introduce e-Invoicing

[1] Bahrain, KSA, Kuwait, Oman, Qatar and UAE

Country	TP Regulations	VAT Regulations	e-Invoicing
			for all VAT registered taxpayers by September 2021.
Jordan	Yes – Introduced in June 2021.	Yes	No - Detailed legislation published.
KSA	Yes	Yes	Yes – Introduced in December 2020, phase 1 will be implemented by 4 December 2021, phase 2 from 1 January 2023 onwards.
Kuwait	None	None	No - Detailed legislation published.
Oman	Limited (only CbCR)	Yes	No - Detailed legislation published.
Qatar	Yes	None	No - Detailed legislation published.
UAE	Limited (only CbCR)	Yes	No- Detailed legislation published.

Short overview of VAT in the KSA

VAT is an Indirect Tax that is levied on the consumption of most goods and services, though some supplies are typically exempt from VAT such as certain financial services, certain real estate transactions, etc. As VAT is a consumption tax, in principle it is ultimately incurred and paid by the end-consumer.

VAT is levied at each stage of the supply chain and (generally) collected by the supplier of the goods and services on behalf of the Government. Generally, businesses are able to recover the "input VAT" they incur on their purchases from suppliers. This input VAT can be claimed against "output VAT" collected from customers. In the case of a surplus the difference is remitted to the Government.

In some instances, businesses are unable to recover the VAT due on costs incurred for various reasons such as, the costs incurred by a business relates to VAT exempt activities or the recovery is specifically disallowed for VAT purposes (e.g. VAT incurred on food and drinks).

Short overview of TP in the KSA

TP refers to the setting of prices for transactions conducted between related persons, including but not limited to the transfers of goods, services, financing, and intangible related transactions. The purpose of TP is to ensure that all transactions between related persons are priced on an 'Arm's Length' basis (i.e., prices that would be charged between independent companies).

TP is a concept used for taxation purposes. It is not in itself a 'Tax' (such as Corporate Income Tax "CIT"). However, the underlying 'Arm's Length' principle of TP should be followed when calculating the taxable income ('Tax Base') of a taxpayer having related-party transactions for the purpose of CIT. This is to ensure that profits are not shifted via related-party transactions from one company to another, thus ensuring that CIT on profit is levied fairly. In case related party transactions are found to be not at an

Arm's Length, a TP adjustment might be proposed by the tax authority to align TP outcome with the Arm's Length result. Any TP adjustment will lead to a recalculation of the CIT tax base of the taxpayer.

At a global level, the development of the TP rules has been heavily influenced by the OECD[2], with the publication and updating of the TP guidelines for multinational companies and tax administrations ("OECD TP Guidelines").

Many individual countries across the globe have introduced TP legislation under their domestic tax laws that is primarily based on the OECD TP Guidelines. In some countries, TP provisions are sheltered under the General Anti Avoidance Rules (GAAR).

ZATCA introduced the TP Bylaws in the KSA in February 2019 and with the issuance of the TP Guidelines, taxpayers have seen additional compliance requirements and a statutory obligation to demonstrate the Arm's Length principle in their related party transactions for the financial years ending 31 December 2018 and beyond.

Taxpayers in the KSA are required to prepare and submit a TP Disclosure Form as part of their CIT return, which provides an overview of the entity's related party transactions (and among other things, the nature of the transactions, the transaction amounts, and the countries of the counter parties). Taxpayers are also required to prepare and maintain a three-tiered documentation package consisting of a TP Local and Master File and a Country by Country Report (CbCR). For the most part, the three-tiered documentation package is in line with the OECD TP Guidelines. An important point to note here is that all these are annual reporting or compliance requirements.

Overview of e-Invoicing in the KSA

The ZATCA has announced a phased approach for the implementation of e-Invoicing in the KSA. While the first phase of the implementation, introduced with a grace period of 12 months, is slated to kick-off with effect from 4 December 2021, the second phase of the implementation is scheduled from 1 January 2023 onwards.

Phase 1 requires resident VAT taxpayers to generate and store e-Invoices. Under Phase 2, taxpayers will need to integrate their e-Invoicing solutions with ZATCA's platform to share data and information with the ZATCA. Phase 2 shall be implemented in a phased manner by targeted taxpayer groups. Taxpayers will be notified by ZATCA on the date of their integration at least 6 months in advance.

e-Invoicing applies to tax invoices, simplified tax invoices, credit notes, and debit notes, etc. As a rule of thumb, e-Invoicing applies to all transactions (by KSA resident taxpayers) if subject to either 0% or 15% KSA VAT. In general, e-Invoicing is not required in respect of exempt supplies, supplies subject to VAT pursuant to a Reverse Charge Mechanism (purchases) and the import of goods into KSA.

From the guidance available thus far, it seems that ZATCA is ultimately heading towards a clearance model for e-Invoicing, wherein the issue of each e-Invoice is declared and authorized by the tax

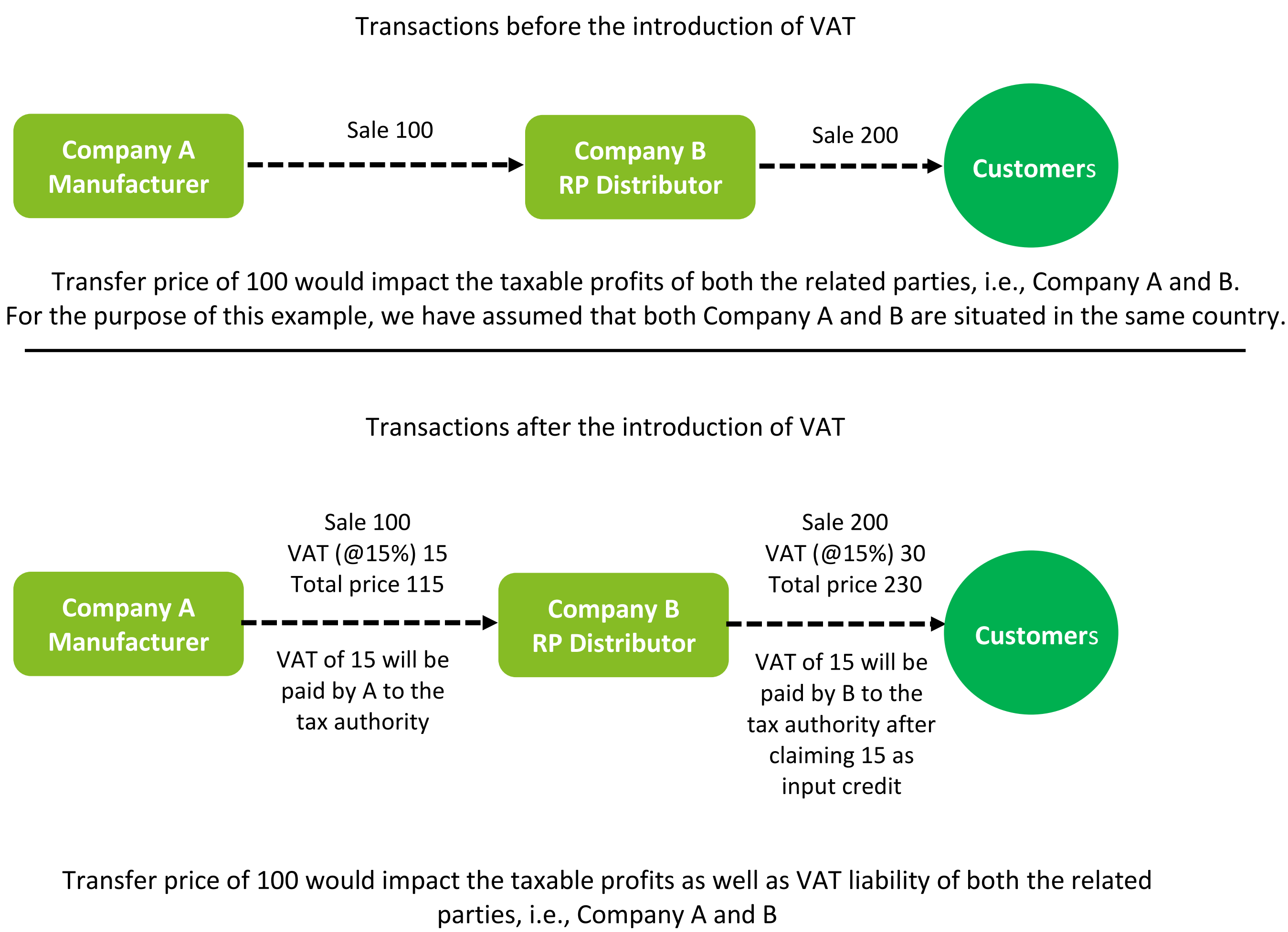
[2] The Organization for Economic Cooperation and Development is an international economic organization with 38 member countries, founded in 1961 to promote economic growth, prosperity, and sustainable development.

authorities. This implies that the tax authority would have (near) real time information about all the transactions that pass through the tax authority's portal.

The Interplay between VAT and TP

VAT is levied on the value (monetary or in kind) of the 'VAT taxable supplies' by a taxpayer. The price charged for the transaction also affects the taxable profits of the entities involved. Therefore, the value of transactions is relevant from both a VAT and a CIT perspective. VAT and TP interactions arise in the case of related party transactions. In case of related party transactions, VAT rules may allow the tax authority to substitute the transaction value agreed between parties with the market value for the purpose of calculating the VAT taxable basis, if the pricing of the transactions is not at fair market value (which often resembles the Arm's Length value). The interaction between VAT and TP has been explained further by the help of the diagram below (Figure 1):

Figure 1: The interplay between VAT and TP.



With the introduction of the e-Invoicing rules, the entire process of invoicing is digitized. In theory this change does not affect the tax treatment of transactions and therefore the VAT and TP position of the taxpayers. Also, it does not change the requirement to accurately account for VAT and other taxes. However, the ZATCA has mentioned in its publications on e-Invoicing that *inter-alia* the objectives of introducing e-Invoicing is increased tax compliance and adopting global best practices. Therefore, it is important for taxpayers to consider the interplay between e-Invoicing and TP while designing their tax processes when the e-Invoicing system is embedded into the existing supply chain transactions or if any changes are contemplated to the supply chain as a result of VAT, TP or tax related considerations.

The interplay between e-Invoicing and TP

Why should taxpayers care about e-Invoicing and having a proper system in place from a TP perspective? Fundamentally, e-Invoicing rules do not trigger any change in the way related party transactions are being conducted by taxpayers. As such, the e-Invoicing rules does not interfere with the application of the 'Arm's Length Principle'. However, taxpayers will have to be more careful with related party e-Invoicing, as it will provide real time information to tax authorities (e.g. ZATCA in KSA). This information could and will likely be used by the tax authority to also assess the TP position of taxpayer's post implementation.

In particular, the following issues should also be carefully considered:

- **System design and year-end TP adjustments**

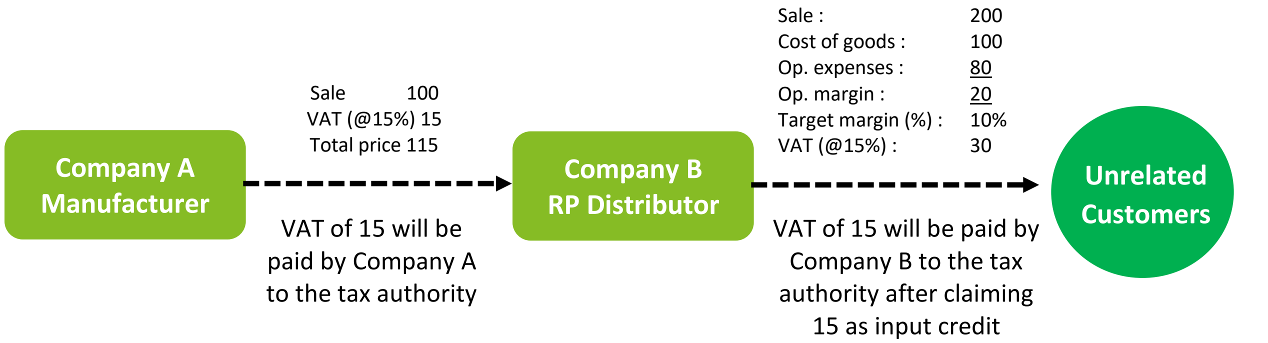
TP is not an exact science and often offers a fair amount of flexibility in its application. In essence, if a TP policy, as set out initially between the related parties, is not met due to reasons beyond their control, the TP Regulations provide flexibility to perform certain adjustments at the year-end (or even subsequently). As an example, in the case of a limited risk distributor, the TP policy could be to earn an Arm's Length target operating margin on sales for the functions performed, assets utilized, and risks assumed by that entity. The target operating margin has to be achieved by setting the transfer price for the goods purchased by that entity from its related party for resale based on forecasts of revenue and operating costs. If actual revenue and operating costs differ significantly from the forecasts, there will be a need for taxpayer to make an upward or downward adjustment to the transfer price in order to achieve the target operating margin at the end of the financial year. Any subsequent change to the transaction value might have an impact on the VAT liability of taxpayer, as additional VAT may be due or excess VAT may have been remitted to the Government. This is explained in the following illustration (Figure 2).

Figure 2: Year-end TP adjustment

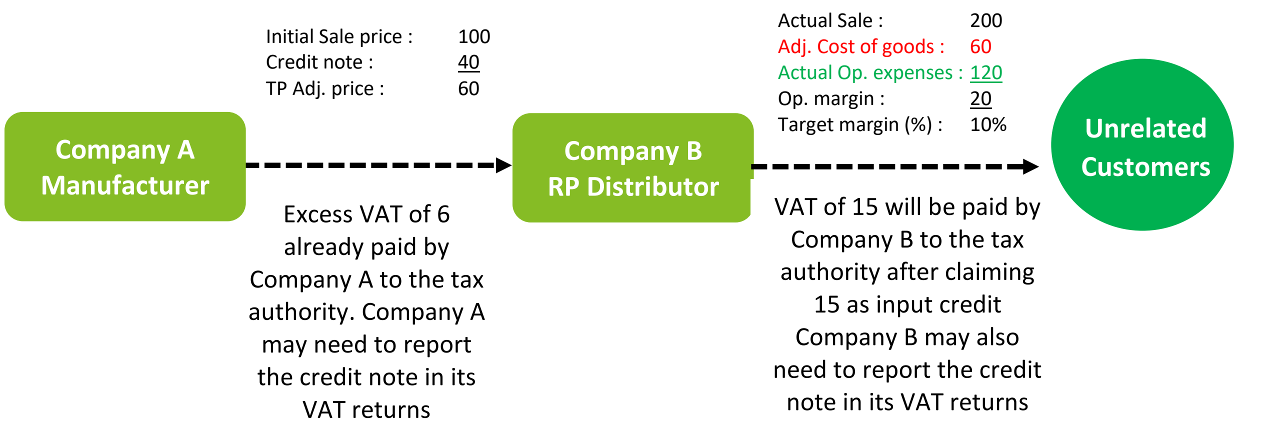
Facts and assumptions:

- Company B needs to earn a target operating margin of 10% on sales as per the TP policy
- During the year, Company B incurred operating loss due to additional actual operating expenses
- If the year-end TP adjustment is made by via credit notes as per the TP policy, this could lead to VAT consequences, as VAT liability under the final transaction is lower than the VAT already paid to the tax authority
- In case no TP adjustment is made, this could lead to challenges by the tax authority from a direct tax perspective due to loss position (not in line with the TP policy and Arm's Length principle)

Based on forecasts for the distribution business



Based on actual results for the distribution business



The TP adjustments could be effectuated in the form of debit/credit notes, supplementary invoices, etc. The e-Invoicing system should provide the flexibility for such adjustments to be performed. The system should be designed in order to identify relevant sources of information flow and links with tax reporting, regulatory requirements and with the internal processes that would ultimately lead to an appropriate TP policy to be adhered to by the related parties. The use of appropriate technology to provide timely information to tax departments is a critical part of such processes and system design. The VAT and TP positions should be assessed based on the domestic tax or TP rules and practice adopted by the tax authority. In case of any subsequent TP adjustment to the value of related party transactions, the VAT impact should be carefully analyzed in order to avoid potential challenges (and non-compliance penalties) from the tax authority.

- **Linking e-Invoicing with Operational Transfer Pricing**

One of the biggest challenges in TP is ensuring that business model and TP policies translate into a simple intercompany agreement that is accurately reflected in the financial statements and records of taxpayers. Operational Transfer Pricing (OTP) can be considered as being the accurate, transparent and efficient implementation of TP policies in the books and records of a company based on quality data, robust processes and controls. Many multinationals consider OTP as a tool for good governance, consistent implementation of TP policies across jurisdictions and transparency in their processes. It is also critical however, for those multinationals to create a bridge between OTP and e-Invoicing.

For example, there could be various types of TP models depending upon the nature of business activities carried out by taxpayers including but not limited to cost plus mark-up (for service providers or manufacturers), return on sales (for distributors), return on assets (for capital intensive industries). In all such cases, an e-Invoicing system should be carefully designed and implemented to reflect the accurate TP policy adopted by taxpayers. We discuss some examples in the following paragraphs.

In the case of a cost-plus TP model, consideration should be given to the definition of 'Cost' to be marked-up. Generally, operating cost is considered for the purpose of a mark-up, and inter-company agreement provides the definition of 'Cost Base', inclusions and exclusions.

As a result of the COVID-19 pandemic, many enterprises have incurred exceptional, non-recurring operating costs relevant to differing operating conditions for the pandemic period. These include expenditure on Personal Protective Equipment (PPE), reconfiguration of workspaces to enable physical distancing, IT infrastructure expenses relating to test, track and trace obligations and to implement teleworking arrangements. Such costs may become permanent if working from home becomes more common as a result of the pandemic and hence, should be considered as an 'Operating Expense' while determining the value of intercompany transactions on which VAT should be levied.

The e-Invoicing system should be configured to capture the accurate TP policy of taxpayers that will influence the taxable basis for VAT purposes. It will be important that there are good processes in place, firstly to reduce the likelihood of significant price adjustments being required and secondly to take the necessary steps to avoid exposures if such adjustments are unavoidable.

So, e-Invoicing: Beyond VAT, what about TP?

Undoubtedly, tax authorities in the Middle East are investing heavily on digitization, data storage, processing, and analytics. Once taxpayers' e-Invoicing systems are implemented and integrated with tax the authorities' systems, the tax authorities will have an enormous database of real time information to process, analyze and use for risk assessment and initiating tax audits (in case there are any gaps found between various records; for e.g. VAT, CIT, Withholding Tax and Customs). With the use of artificial Intelligence, tax authorities will soon be able to compare millions of transactions from the taxpayers.

On this basis, taxpayers should focus on a more transparent and coordinated strategy.

Group's strategies on designing an appropriate e-Invoicing system must be aligned with the TP policy being followed between the related parties and wherever possible, with the OTP system implemented by these groups. Any deviation from the standard TP policy should be dealt with care and properly captured in the e-Invoicing system. In fact, the e-Invoicing system should provide the flexibility to accommodate any TP adjustments at a later stage. On this basis, taxpayers should proactively do a TP impact assessment in order to manage the risks arising from implementing the e-Invoicing system.

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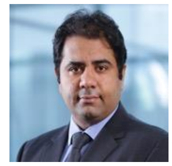

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