



Transfer Pricing Audit Developments in the Middle East

Practical cases
and immense challenges

June 2022

Transfer Pricing (TP) continues to be an evolving topic as many jurisdictions in the Gulf Cooperation Council (GCC) and Levant are introducing, or are anticipated to introduce, full-fledged TP regulations. The TP landscape continues to grow in the region which includes interesting TP audit developments over the past 12 months.

With the introduction of the TP Bylaws in February 2019 in the Kingdom of Saudi Arabia (KSA), we have seen a significant increase in the volume of new TP audits initiated by the Zakat, Tax and Customs Authority (ZATCA) in the second half of 2021.

In this publication, we provide an overview of the current TP environment across key jurisdictions in the GCC and Levant, TP audit processes in KSA, practical TP cases we have seen to date and, the challenges faced by taxpayers.

Updates on the latest TP audit developments in the State of Qatar, the Hashemite Kingdom of Jordan and the Sultanate of Oman and other countries in the GCC are also covered throughout this publication.

The current TP landscape

With the introduction of TP regulations in countries such as KSA and Qatar, we have seen a major shift in the tax landscape among multinationals operating in the region. We have also seen TP audits and related party transaction adjustments in jurisdictions where no formal TP regulations are in place, like Oman and Kuwait.

The table below provides a summary of the status of TP regulations in key GCC countries and Jordan.

Jurisdiction	Status of TP Regulations
Kingdom of Saudi Arabia	Complete TP regulations in place since February 2019.
State of Qatar	TP regulations applicable for the tax year 2020 onwards.
State of Kuwait	No TP regulations exist to date. Reference to related party pricing is made in the Income Tax Law.
Sultanate of Oman	Only Country-by-Country Reporting (CbCR) regulations exist to date. Reference to related party pricing is made in the Income Tax Law.
Hashemite Kingdom of Jordan	TP regulations applicable for the tax year 2021 onwards.

In the United Arab Emirates (UAE) and Bahrain, both countries have introduced CbCR and Economic Substance Regulations (ESR). This has transpired due to their commitments as members of the Organization for Economic Co-operation and Development's (OECD's) Inclusive Framework. In the UAE, TP regulations are anticipated as part of the Corporate Income Tax (CIT) legislation to be applicable for financial years starting on or after 1 June 2023.



TP audits

To date, we have seen TP audits and reviews commence in KSA and Oman. Although developed TP regulations have been operational in Qatar for over two years, our experience suggests that limited TP audit activity has been experienced by taxpayers in Qatar thus far.

In Kuwait, taxpayers have also been subject to TP related proceedings primarily based on the tax authorities' approach of proposing adjustments based on a deemed profit earned by taxpayers.

Below is an overview of what triggers a TP audit and the overall TP audit process in the KSA, including the latest developments observed.

Triggers of a TP audit

Among other criteria, and based on our experience, KSA's ZATCA selects TP audits and enquiries based on the following attributes:

- The value and nature of intragroup transactions (e.g., intragroup royalty payments or a high-level of service fee charges).
- Entering transactions with related parties located in low or no tax jurisdictions or tax havens (e.g., the UAE, Bahrain, the British Virgin Islands and Cayman Islands).
- Consistent loss makers or reporting low margins; and
- Recent business restructurings.

Much of the above information is obtained from taxpayers' annual TP disclosure forms, which provides ZATCA with an effective risk assessment tool.

Other sources of information used as part of ZATCA's risk assessment process are taxpayers' CbCR. The ZATCA seem to be particularly interested in reviewing whether taxpayers are transacting with countries like the UAE or Bahrain, where the CIT rate is currently zero percent. During TP audits and litigation in KSA, we have seen CbCRs be used and referenced as a source of information by ZATCA.

Overview of the audit process

At a high-level, the TP audit process usually begins with the tax authority requesting the taxpayer's TP documentation, their TP policy, intragroup agreements, and any other relevant supporting information.

As a next step, the tax authority may conduct an interview with the taxpayer. In KSA, since early 2020 at the start of COVID-19, all taxpayer meetings and interviews continued to be carried out virtually. During the meeting, the tax authority seeks to better understand the KSA taxpayer's business, its interaction with its related parties and other topics depending on the case. For example, establishing where and by whom critical business decisions are being made. Following such interviews, meeting minutes may be issued by ZATCA, and the taxpayer is asked to confirm and sign against this information.

In addition to virtual interviews, ZATCA have also commenced field audits whereby the audit team visit the taxpayer's physical premises to gather information via this approach.

We also continue to see ZATCA request information, including financial statements, customer contracts and other information under a double tax treaty from the taxpayers' overseas jurisdiction where the operational presence of the group transacts with the KSA taxpayer. This information has been used as primary evidence in a number of TP disputes in KSA.

Once ZATCA is satisfied with the level of information collected, it will either close the case if no risks are identified or outline its position based on its understanding of the taxpayer and the information made available. The tax authority may communicate its position through draft tax assessments and provide reasons for any TP adjustments. Alternatively, final tax assessments containing TP adjustments may be issued. Taxpayers can challenge these assessments through the available dispute procedures in KSA.

Taxpayers may also invoke the Mutual Agreement Procedure (MAP) to resolve any double taxation that may result from a TP adjustment. We are aware of a number of MAP cases being filed during 2021 and 2022 relating to double taxation incidents arising from TP assessments issued by ZATCA. We expect the number of MAP cases with the KSA Competent Authority to increase going forward. Further, KSA has formal settlement procedures whereby taxpayers can request a final assessment.

In most cases, ZATCA have been issuing a comprehensive TP report alongside the draft tax assessments prior to finalizing its position (i.e., issuing final tax assessments). The TP report outlines the taxpayer's position, the tax authority's understanding, the proposed TP adjustments, and the legal basis for the proposed adjustments. The taxpayer is given the opportunity to respond to the report and draft assessments and provide any additional information they deem relevant. After considering any additional information provided, if ZATCA's position remains unchanged, the tax authority will issue final assessments.

Practical cases

KSA

Given the way in which initial phases of TP audits progress in KSA, this usually leaves taxpayers with no option but to consider settling the case with the KSA's Internal Settlement Committee or appeal the assessments to the General Secretariat of Zakat, Tax, and Customs Committees (GSZ-TCC) i.e., the tax appellate committees in KSA.

A key dispute area with ZATCA has been around cases where the functional profile of a taxpayer has been recharacterized to a limited risk service provider and there has been a subsequent adjustment of the taxpayers' profitability to the median of a comparability analysis. This has been common among loss making entities or entities earning low profit margins.

In such cases, it has been regularly observed that ZATCA has argued that recharacterization should occur because:

- The only reason for a KSA entity to incur losses is because the entity is part of a Multinational Group of Entities (MNE).
- The local entity's parent entity or Head Office has control over the local entity in KSA or makes key decisions relating to the KSA entity's business in the Kingdom; or
- The only reason the local entity exists is so that the group has a presence in the Kingdom.

The above reasons are relied on by ZATCA as a basis for viewing the losses or low margins achieved by the taxpayer as being non-arm's length.

In addition to the above reasons, recharacterization of a limited risk service provider to a full-fledged service provider or even an entrepreneur has also been witnessed, enabling ZATCA to increase the profitability of a taxpayer and claim TP adjustments in such cases.

Other instances of recharacterization have also been witnessed with regards to intercompany loans being recharacterized as equity contributions. This is on the basis that a borrowing taxpayer does not have the required creditworthiness to obtain such a loan, the loan being unsecured and/or loan repayments not being made.

Once ZATCA reaches a position that a recharacterization needs to be made, it will seek to adjust the profitability of the entity to the median of a given comparability analysis. This median percentage can be reached by either:

- ZATCA performing its own comparability analysis.
- ZATCA applying the median of the taxpayer's own comparability analysis; or
- Partially or fully merging the comparability sets of the Authority with that of the taxpayer and reaching a new median result.

Whilst reviewing the comparable data of the taxpayer's comparability analysis, ZATCA may reject certain comparable data it does not agree with. For example, the independent



entity performing different functions than the tested party or the comparable lacking qualitative or quantitative information.

In view of the above, and specifically for taxpayers utilizing the Transactional Net Marginal Method (TNMM), it is very critical to carefully review the set of comparable companies and perform a screening exercise when preparing the benchmarking study to limit any potential challenges of the comparable company's sample.

It is noted that ZATCA often applies TP adjustments for all years available to be assessed i.e., years that are within the statute of limitation.

The likelihood of ZATCA changing its initial position after issuance of a tax assessment related to TP, is low based on experience. Many taxpayers have therefore escalated their case to the GSZTCC with a number of wins in favor of the taxpayer at the Tax Dispute and Violation Committee (the first level of the GSZTCC).

There has been little experience of GSZTCC engaging any TP experts as part of their process in reaching a decision on a TP adjustment being disputed before the appellate committees. What has been key to many of these wins is how the taxpayer and their advisor communicate their position in a simple and clear manner to the members of the appellate committee. Further, where ZATCA have undertaken a profitability adjustment on an entity's entire profit and loss statement, which effectively adjusts the taxpayer's related and non-related party dealings, providing adequate and sufficient supporting documentation on the taxpayer's related party transactions has proved hugely beneficial.

Deemed profit adjustments ranging from 20% to 40% also remain a common dispute area between ZATCA and taxpayers. When a taxpayer's tax returns and audited financial statements are filed on time, and documentation produced, including benchmarking analyses, providing evidence of the arm's length nature of a taxpayer's TP policy, has resulted in many wins for taxpayers at the GSZTCC.

Practical cases

Qatar and Oman

As mentioned previously in this article, although fully-fledged TP regulations have been introduced in Qatar for over two years, only minor TP audit activity has been experienced by taxpayers in the country.

In Oman, where no operational TP regulations exist to date, we have seen the tax authority challenge local entities materially transacting with their affiliates in the UAE and Bahrain. Tax assessments containing arbitrary disallowances of related party expenditure in the range of 20% to 25% have been witnessed. These arbitrary adjustments are concluded as part of CIT audits and are based on the existing Income Tax Law.

What is interesting to note in Oman is the Tax Authority's willingness to cancel the tax assessment adjusting related party prices or reach a reasonable settlement with taxpayers.



Immense litigation challenges ahead: Are you ready?

With the introduction of TP regulations in the GCC and the wider Middle East region and the audit developments highlighted above, this has now required global and GCC headquartered MNEs to carefully review their allocation of income and profits to these countries and ensure they are in line with the arm's length principle.

In addition to having a robust TP policy and strong defensible TP documentation in place, MNEs should be aware of how their TP policy and supporting documentation could be used and interpreted by the tax authority during a TP audit.

TP has been an easy target for tax authorities across the world and the ME region is no exception, especially during these uncertain times when tax collection from other sources come under pressure due to economic and political factors.

MNEs' careful management of their overall TP controversy strategy is key to their success in any future case. Being aware of the procedural matters surrounding a dispute process also remains critical. However, other matters such as submitting certain supporting documentation at the right time during the audit process and presenting convincing oral submissions during a hearing have proved crucial and extremely important in some of the cases we have led.

TP controversy lifecycle management

Whilst taxpayers have experienced some wins in KSA at the GSZTCC, it remains a challenge for many to successfully defend their case before the committees. Among other challenges there are local language requirements, producing supporting documentation in Arabic as per the applicable law, shorter statutory dispute timeframes compared to other mature jurisdictions and the limited number of TP cases dealt with historically by the judiciary system. These factors pose immense challenges for many taxpayers.

Deloitte can help

When TP controversies or disputes arise, the Deloitte Middle East TP professionals provide assistance with:

- Responding to any TP documentation and information requests.
- Attending taxpayer audit and functional interview meetings.
- Developing technical arguments and drafting advisory opinions.
- Drafting and filing of objections and appeals.
- Settlement.
- Appeals and representation with authorities.
- MAP; and
- Post controversy advisory services.

By bringing negotiation experience across all industries and Middle East jurisdictions we can help companies advance negotiations with tax authorities and manage penalty exposures.

The Deloitte Middle East TP practice specializing in TP controversy include lawyers, accountants, auditors, economists, former tax authority officials, and industry specialists.

Deloitte Middle East employs a number of TP Arabic speaking professionals who are able to assist throughout all stages of the TP controversy lifecycle and communicate with the GCC tax authorities in their official language. By developing a thorough understanding of each company's specific challenges and aligning dedicated specialists Deloitte Middle East can bring the right resources to the issue to get the right result.

Contacts


For further information, please get in touch with our experts listed below if this is relevant to you.



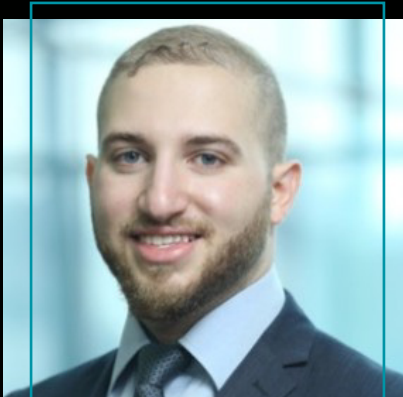
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