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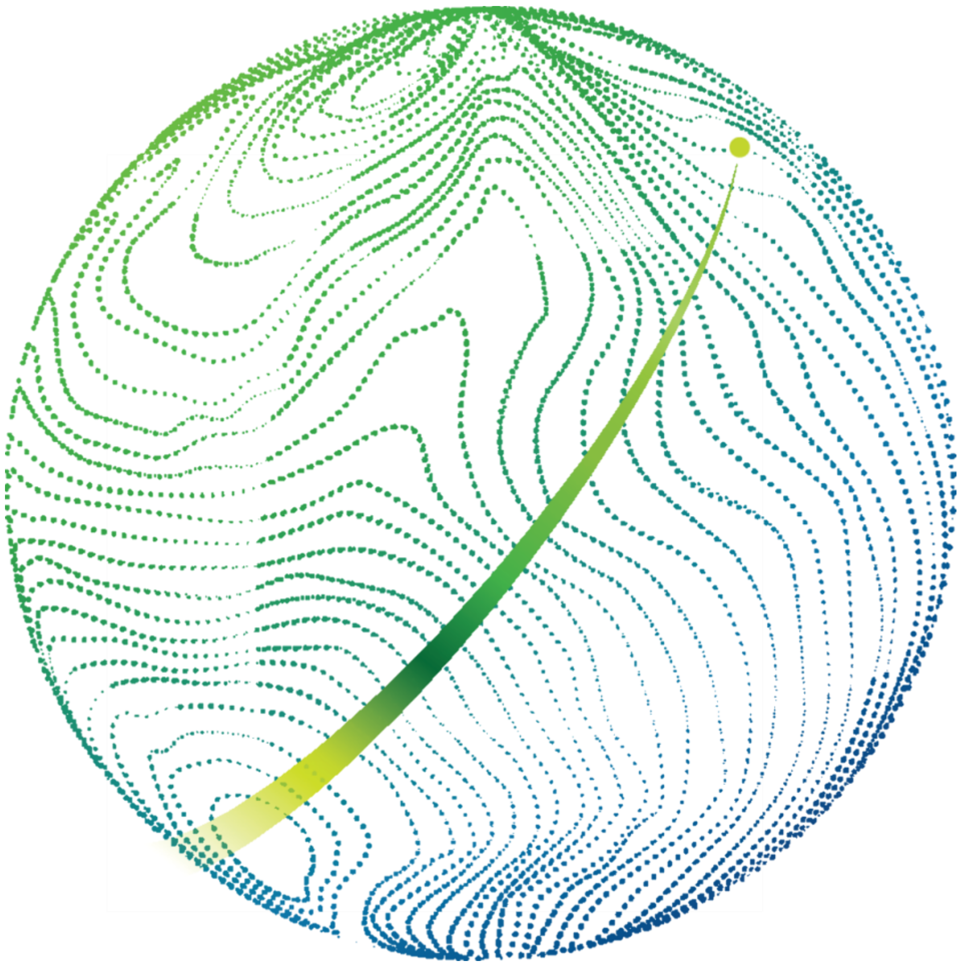

Transfer Pricing Audits in the GCC: Myth or a hard reality?

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Introduction

With the current pandemic affecting all GCC countries, GCC economies facing headwinds and lower anticipated revenues in future years from oil, there are mounting pressures on tax authorities to collect tax revenues to fund government expenditure and balance budget deficits. Given this context, are Multinational Enterprises (MNEs) operating in the GCC facing TP audits in reality? And if so, what information is usually sought by tax authorities during such audits? How do they use and interpret such information submitted during such TP audits?

In this article we provide an overview of the current TP audit environment, specifically focusing on the following aspects:

- The current TP environment in the Gulf Cooperation Countries (GCCs);
- The triggers of a TP audit and an overview of the audit process; and
- Insights on administration of the GCC TP regulations and how audits and disputes are being managed by tax authorities.

This article focuses on the Kingdom of Saudi Arabia ("KSA"), State of Qatar ("Qatar") and the Sultanate of Oman ("Oman"). References to other countries in the GCC are also made throughout this article.

Overview of the current TP environment

With the introduction of fully-fledged TP regulations in countries like 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, for example, in Oman and Kuwait.

Fully-fledged TP regulations

The Zakat, Tax and Customs Authority (ZATCA) (formerly known as the General Authority for Zakat and Tax (GAZT)) introduced the TP Bylaws in KSA in February 2019 and with the issuance of TP Guidelines, taxpayers have seen additional compliance requirements and a statutory obligation to implement the arm's length principle in their related party dealings for financial years ending 31 December 2018 and beyond.

Taxpayers in the Kingdom are required to prepare and submit a TP Disclosure Form as part of their corporate tax return, which provides an overview of the entity's related party dealings (and among other things, the nature of transactions, transaction amounts and countries of the counterparties). Taxpayers are also required to prepare and maintain a three tired documentation package consisting of the local and master file document and a Country-by-Country Report ("CbCR"). For the most part, the three-tiered documentation package is in line with the OECD TP Guidelines. It is worth noting that the Income Tax Law contains an anti-avoidance provision dealing with mismatches in the pricing of related party dealings compared to those of independent parties, which has been in place prior to the introduction of the TP Bylaws.

In Qatar, where fully fledged TP Regulations have also been introduced, taxpayers must comply with the arm's length principle and the additional documentation requirements set forth in the regulations. These regulations are applicable for financial years starting on or after 01 January 2020. Like KSA, a TP disclosure form must be filed as part of annual corporate tax return and local and master file documentation must be maintained by taxpayers engaged in related party dealings (certain thresholds apply). Taxpayers exceeding certain thresholds must also submit their TP documentation to the tax authority on an annual basis.

Limited or no TP regulations

Oman, with no fully-fledged TP regulations in place to date and where the Income Tax Law contains a reference to arm's length pricing, has also seen the tax authority be more active in challenging related party dealings with low or no tax jurisdictions. Based on recent developments in the Middle East's tax and TP landscape, the country's recent introduction of CbCR regulations and its falling oil revenues and spending cuts, it is likely that fully fledged TP regulations could be introduced imminently.

Kuwait has also seen several challenges by the tax authority to taxpayers' related party dealings under the Tax Law which includes a reference to intercompany transactions. This has been in the form of deemed profit challenges, whereby the tax authority assesses a deemed profit margin based on the taxpayer's business activities. Kuwait is not a member of the OECD's Inclusive Framework, nor has the country introduced any other taxes (e.g. VAT) like other GCC member countries. It is unlikely that fully fledged TP regulations will be introduced in Kuwait soon.

In the United Arab Emirates ("UAE") and the Kingdom of Bahrain ("Bahrain"), both countries have introduced CbCR and economic substance regulations. This has come about due to their commitments as members of the OECD's Inclusive Framework and to ensure they are not included in the European Union's Blacklist of Uncooperative Jurisdictions. It is unlikely that fully fledged TP regulations will be introduced by the UAE or Bahrain until such time that Corporate Income Tax ("CIT") is introduced in these countries.

TP audits

To date, we have seen TP audits and reviews commence in KSA and Oman. Minor TP audit activity has also been experienced by taxpayers in Qatar, which we expect to increase once the first TP compliance cycle is complete in 2021. As mentioned previously, taxpayers in Kuwait have also been subject to deemed profit challenges.

Triggers of a TP audit

In general, we have seen tax authorities like the KSA's ZATCA select TP audits and enquiries based on the following criteria:

- The value and nature of intragroup transactions (for example, intragroup royalty payments);
- Entering into transactions with related parties located in low or no tax jurisdictions or tax havens;
- Consistent loss makers or those companies reporting low margins; and
- Those companies involved in recent business restructurings.

Much of the above information is obtained from the taxpayer's annual TP disclosure form, which provides tax authorities with an effective risk assessment tool.

Other sources of information used as part of a tax authority's risk assessment process is the Multinational Enterprise's (MNE's) CbCR. Tax authorities in the GCC seem to be particularly interested in reviewing whether taxpayers are transacting with countries like the UAE or Bahrain, where the CIT rate is zero percent. Assessing the allocations of income and profits to these zero tax jurisdictions, as part of their Base Erosion and Profit Shifting ("BEPS") risk assessment, is of particular interest.

In KSA, CbCRs are a source of information we have seen ZATCA use during TP audits. We expect to see a similar trend in Oman once the tax authority receives its first set of reports by the end of 2021 and the reports of other constituent entities through its CbC exchange network. Qatar, the UAE and Bahrain are non-reciprocal jurisdictions for CbCR purposes, meaning they will not receive any CbCRs from their CbC exchange network.

Overview of the audit process

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

As a next step, the tax authority conducts a functional interview with the taxpayer. In KSA, GAZT has been active in carrying out field audits. In light of the COVID-19 pandemic, all taxpayer meetings and interviews have been carried out virtually. During the meeting, the tax authority seeks to better understand the 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. Afterwards, meeting minutes may be issued by the tax authority and the taxpayer is asked to confirm and sign against these.

The tax authority may request additional information and supporting documentation to be provided after the functional interview. Additional information pertaining to the MNE's transfer pricing arrangements can also be obtained via information sharing under the various double tax treaties concluded by the jurisdiction in question. We have seen many instances, for example in KSA, where ZATCA have requested information on the taxpayer's overseas' related parties, including financial statements, customer contracts and other information. This information has been used as primary evidence in TP disputes in KSA.

Once the tax authority 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 TP adjustments. Alternatively, final tax assessments containing TP adjustments may be issued. Taxpayers are able to challenge these assessments through the available dispute procedures available in each jurisdiction. Taxpayers may also invoke the Mutual Agreement Procedure (MAP) in certain GCC jurisdictions to resolve any double taxation that may result from a TP adjustment. Further, jurisdictions like KSA have formal settlement procedures whereby taxpayers have the ability to request from the tax authority to settle the final assessments.

In KSA, 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.

Tax authorities may conduct CIT, WHT and/or VAT audits alongside a TP audit. It is noted that no GCC jurisdiction to date has a formal Advance Pricing Agreement procedure in place. However, taxpayers have the ability to request rulings covering their intragroup transactions, where a rulings program is in place.

Insights into how tax authorities are administering their TP regulations and audits are being managed

Whilst taxpayers can be confident about their TP documentation and pricing of their related party transactions, it is important to understand how the information provided could be used and interpreted by the tax authority.

KSA

ZATCA have a standalone TP team in place to administer the KSA TP By-laws with TP information requests and audits having commenced as early as the second half of 2019. Common TP challenges we see from ZATCA are:

- A recharacterization of the functional profile of an entity to a limited risk service provider earning a stable return, especially in cases where the taxpayer is a loss maker or earning low margins;
- Applying profitability adjustments to a taxpayer's operating financial results (in many cases, as a result of a functional recharacterization of the taxpayer);
- Roll-back adjustments to prior tax years (up to 5 years) using the median of a benchmarking study produced by the taxpayer or ZATCA, although the there is no provision in the TP By-laws for a retrospective application;
- A recharacterization of intercompany loans to equity injections, where the borrower is not deemed by ZATCA to have the capacity to bear the risks associated with the loan or make payments when they fall due;
- The disallowance of royalty payments to related parties, especially where royalty payments are made over multiple years and/or to an affiliate located in a no or low tax jurisdiction; and
- Introducing additional comparables to a taxpayer's benchmarking set.

It is also interesting to note that the TP adjustments are made to Zakat payers as well and not restricted to corporate income taxpayers only. Taxpayers need to be wary that information provided in their disclosure form and TP documentation could be used in non-TP matters. For example, ZATCA has been issuing WHT assessments for related party transactions included in the disclosure form or included within TP documentation. ZATCA may reach a view that a certain transaction is subject to WHT or a higher rate of WHT than that already withheld. Where a taxpayer has applied WHT on a bundle of transactions, ZATCA has reviewed information included in the TP documentation against the withholding tax returns to assess whether the correct rates have applied to various payments included in the bundle.

Permanent establishment risks associated with a taxpayer's head office entity or other overseas affiliates should be considered as part of any TP audit or review. ZATCA may attribute profits of an overseas affiliate based on information contained in the TP documentation of the taxpayer.

VAT and customs on transfer pricing service payments and year-end adjustments need to also be closely reviewed and accounted for correctly. ZATCA may review these transactions from a VAT and customs perspective to assess whether VAT and customs have been correctly applied.

Qatar

Qatar would have only received the first set of TP disclosure forms in June 2021. It is unclear whether the General Tax Authority of Qatar employs dedicated TP specialists as part of their compliance or audit departments. However, we do foresee TP audits and disputes to significantly increase in the near future in Qatar as the tax authority collects its first round of data from the disclosure forms and TP documentation submitted by taxpayers.

Oman

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

It is interesting to see this approach in Oman where the counterparty is domiciled in a no or low tax jurisdiction. It resembles part of the Pillar Two approach put forward by the OECD. The tax authority in a way is granting itself the right to tax related party transactions where other jurisdictions have not exercised their primary taxing rights, or the payment is otherwise subject to low levels of effective taxation. We expect to see more sophisticated TP reviews and audits in Oman once the country introduces fully-fledged TP regulations.

GCC TP Audits: Myth or hard reality?

With the current pandemic affecting all GCC countries, GCC economies facing headwinds and lower anticipated revenues in future years from oil, there are mounting pressures on tax authorities to collect tax revenues to fund government expenditure and balance budget deficits.

Given the introduction of TP regulations in the GCC and the wider ME region, 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 countries like KSA, we have seen an immediate response from the tax authority actively administering and reviewing taxpayers' TP affairs. Hence a similar response is expected from other tax authorities in the region as they introduce fully-fledged TP regulations.

In addition to having a robust TP policy and strong defendable 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.

In addition, 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.

Given all these developments, corporate income taxpayers in the GCC are encouraged to review their open tax years especially FY 2016 to 2018 to assess exposures from a TP perspective.

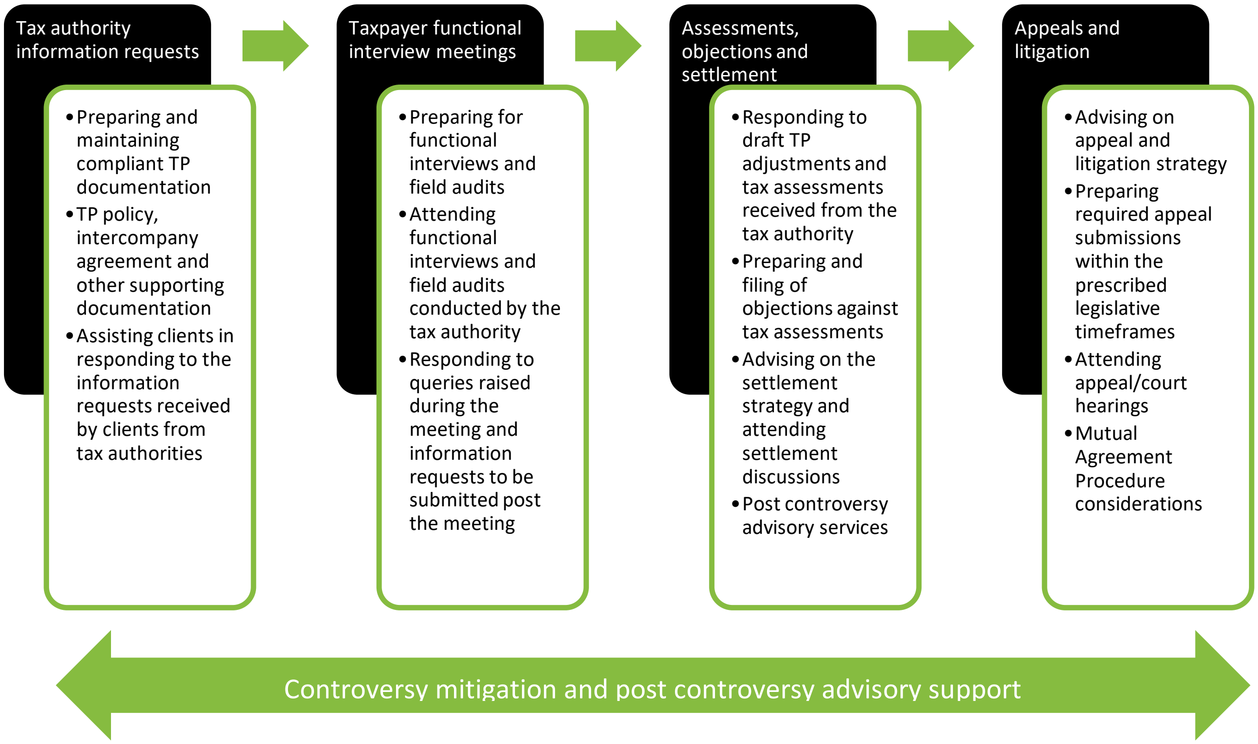
As we see an increase in TP audits and disputes in the GCC region, this will translate into many cases being litigated at the courts of each respective country. We are yet to see how these cases will be resolved at the judicial level given the technical complexity of certain TP cases and the lack of experience of the respective countries' court systems in dealing with TP issues. Time will tell, but right now, TP audits in the GCC are a hard reality for many MNEs and certainly no myth that's for certain!

TP controversy lifecycle management

With the increasing number of tax and TP requirements being introduced by GCC countries and their tax authorities becoming more sophisticated in how they target high profile and high risk areas, it is recommended that taxpayers immediately consult with their tax advisor in the event of a TP audit or dispute. Consulting with tax advisors on how to mitigate any future TP controversy risks is also advisable given the higher risk of tax authorities opening previous tax years, which often results in high penalties being imposed.

Every tax controversy is unique, time sensitive and requires a lot of resources from the taxpayer's management to manage and resolve. At Deloitte Middle East, we have developed a TP controversy framework to assist our clients in effectively managing their TP disputes throughout all stages of the TP controversy lifecycle. This is illustrated below.

Deloitte TP Controversy Framework



By bringing negotiation experience with other industries and jurisdictions we can help companies advance negotiations with tax authorities and manage penalty exposures. The Deloitte Middle East TP team 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 cycle and communicate with 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.

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