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# Are exclusive distributors subject to new transfer pricing rules in KSA?

**New KSA TP rules and compliance requirements**

The General Authority for Zakat and Tax ('GAZT') released final transfer pricing (TP) bylaws on 15 February 2019.

The regulations will be effective for transactions that took place in FY18 and introduce the following new compliance requirements:

- A disclosure form setting out the related persons and intercompany transactions which must be submitted to the GAZT by April 2019 (for FY ended December 2018); and
- A local file and a master file which must be produced within 30 days upon request (there will be a 60 day extension/grace period for 2019 requests).

This article sets out our initial view on the applicability of TP regulations in respect of exclusive distributorship arrangements in KSA, particularly in light of Art. 1, A. cipher 12 (i) of the bylaws.

The bylaws apply to all taxpayers (i.e. "taxable persons") and cover any transaction between related persons or persons under common control. We note that 100% Zakat payers are exempt from the above compliance requirements (but not from the country-by-country reporting requirements).

**The effective control test in respect of exclusive distributorship arrangements**

The bylaws provide a detailed definition for related persons, which has some consistency with OECD standards; however, it is worth mentioning that the rules establish that two persons would be considered related persons if they are persons under common control or if one has effective control over the other. Effective control in this context is a far reaching concept and more comprehensive than the OECD standards.

The definition of effective control includes 11 transactional tests designed to isolate effective control through business dealings; in other words, where one person is over-reliant on the other from a business perspective, and thus creating a potential control relationship. Among other transactional tests, the test under Art. 1, A. cipher 12 (i) of the bylaws establishes a control relationship where there is:

> Jointly or severally the principal or supplier under an exclusive agency, distributor arrangement or similar contract for the sale of goods, services or rights AND a dependent agent who is prohibited from entering into other similar agency, distributorship or any similar arrangement for the duration of the principal-agent's relationship.

Therefore, in a typical buy-sell arrangement, a foreign supplier and a local distributor in KSA would be qualified as related persons (even if they are independent parties) and, therefore, subject to transfer pricing rules in KSA, provided that they meet the following two-step test:

1. Exclusivity: The bylaws require that the distributor is appointed to provide services or sell goods on an exclusive basis; AND

2. Dependency: The bylaws require that the distributor is sufficiently dependent.

### Exclusivity of arrangements

It is common practice for multinational enterprises (MNEs) to enter into exclusive distributorship agreements in KSA, which would stipulate certain limitations for the foreign supplier in respect of the territory and products covered by the distribution agreement. For example, such agreements typically specify that:

> 'The supplier shall not sell the products (as per the agreed list of products) in the territory of KSA to any person other than the distributor without the prior written consent from a distributor'.

Therefore, we would expect that many distributorship arrangements would satisfy the first condition of the test and, as such, the second condition would have to be considered further.

### Dependent agency relationships

The second condition requires that the KSA distributor is treated as a 'dependent agent' of the supplier/principal. Based on the wording of the bylaws it seems that the 'dependency' is solely defined by the fact that such agent is "is prohibited from entering into other similar agency, distributorship or any similar arrangement for the duration of their relationship".[1] This condition stipulates a non-compete clause for the distributor. An example for such a clause is given hereafter:

> 'The distributor shall not manufacture, import, export, sell, distribute or otherwise deal with any products the same as, competitive with or similar to the products which are covered by the distributorship agreement'.

It is important to note that the bylaws lack specific guidance on "similar" arrangements. We would expect that similarity will be required in terms of the product itself. Whether GAZT will provide further guidance on this is unclear and it may have to be seen how it will play out in practice in the Kingdom.

Based on the current broad wording of this test, we would expect many MNEs to meet the dependency condition in KSA. Accordingly, the relations between MNEs and local distributors in KSA may be subject to KSA TP rules, including the requirement to report such transactions in the disclosure form as well as in the local/master file. In such case, in order to meet the transfer pricing compliance requirements, both parties would need to cooperate and this may not be necessarily possible due to the disclosure of sensitive information.

### Impact on businesses

Exclusive distributorship arrangements are widely used across different sectors, including consumer products, pharmaceuticals, and oil and gas. As noted above, in light of the 'exclusive distributorship test' (Art.1 para.12 (i) of the bylaws), it is likely that such arrangements will fall under TP compliance requirements in KSA.

In addition to the 'exclusive distributorship test', there are number of other transactional tests, which might trigger TP reporting obligations in KSA. For example, a 'volume of transactions' test could also be relevant to many MNEs operating in the country. The test is met when "50% or more of the absolute aggregated value of a Person's business activities depend on Transactions with other Person(s)".

In light of the above, we recommend that MNEs that operate through third party distributorship models undertake in-depth analysis of the related persons/effective control position, including a review of the exclusive distributorship agreements/arrangements. This analysis would be crucial for the completion of the disclosure form and would determine if a local/master file will be required for relationships that many would view to be third party and arm's length.

1. We note a definition of 'dependent agent' can be found in Art. 4 of the Income Tax Bylaws (Permanent Establishment). According to such definition, a dependent agent has any of the following authorities:
a. Negotiate on behalf of a non-resident,
b. Conclude contracts on behalf of a non-resident,
c. Have a stock of goods in KSA, owned by a non-resident, at their disposal to supply clients' demands on behalf of the non-resident.
It seems unlikely that such definition has no or limited bearing for purposes of the definition of 'dependency' for purposes of the Effective Control test under Art. 1, A. cipher 12 (i) of the bylaws.

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