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Transfer pricing implications of regional disruption for multinational businesses in the Middle East

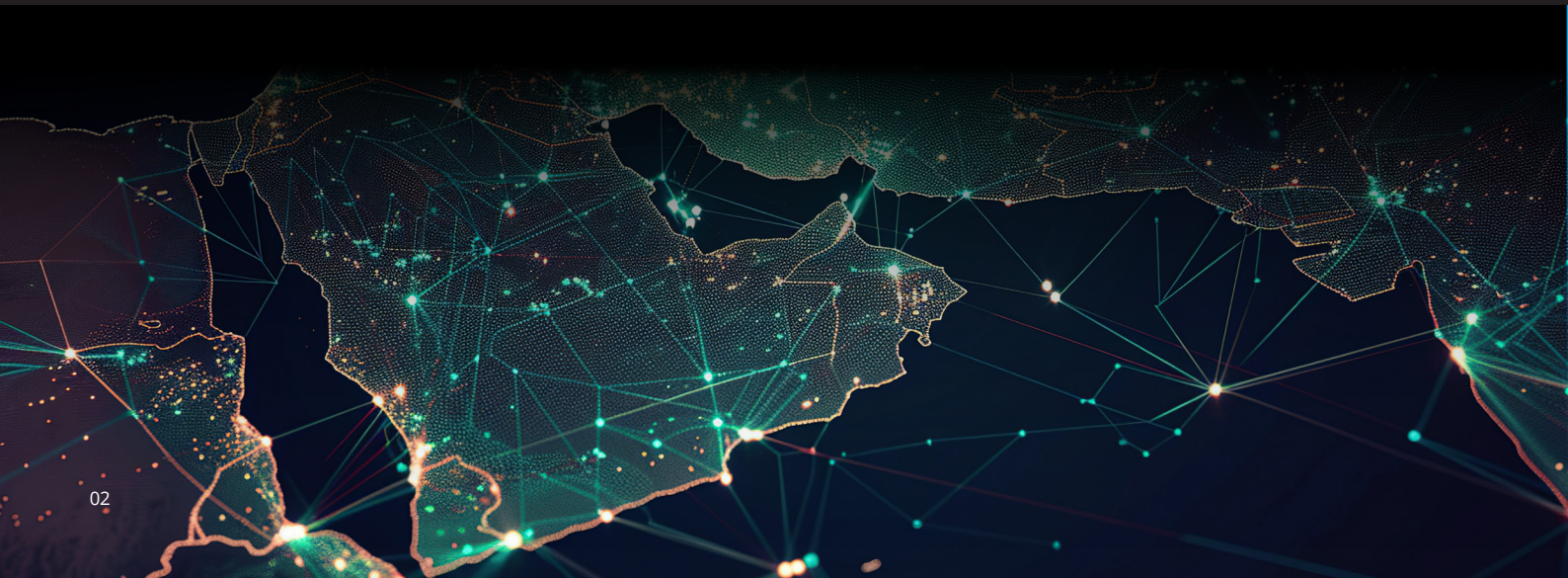


Transfer pricing frameworks are built on assumptions about how value is created within multinational groups. Functions are performed in defined locations. Risks are allocated to entities that have the capacity to bear them and the decision-making authority to manage them. Assets are deployed where the business model requires them. Supply chains connect production to distribution through established corridors, and the pricing of intercompany transactions reflects the economic reality of how those corridors operate.

The current regional disruption has challenged many of these assumptions simultaneously. Maritime trade routes through the Strait of Hormuz have been curtailed, forcing the physical rerouting of goods through alternative corridors. Workforces have been displaced, with key personnel relocating from the Gulf to the Levant, North Africa, Europe, and beyond. Contractual commitments are being tested against force majeure thresholds. And the operational infrastructure that underpins the regional hub model, including ports, airports, data centers, and logistics networks, has been subjected to direct physical disruption.

For transfer pricing purposes, the critical question is not whether the disruption is temporary or permanent. It is whether the intercompany pricing arrangements that were calibrated to pre-disruption conditions continue to produce arm's length outcomes under current conditions. In many cases, the answer is that they do not, and the adjustments required to restore arm's length pricing are not year-end corrections but real-time recalibrations that need to be documented as they happen.

This article examines the key transfer pricing implications of the current disruption for multinational businesses operating in the Middle East. It is intended to be practical and actionable, providing a framework for identifying where existing TP arrangements are under stress and what steps should be taken now to protect the business's compliance position.





Why a regional disruption is more complex than a global one

During COVID, transfer pricing practitioners around the world faced a common problem: how to justify intercompany pricing when every market was disrupted simultaneously. The OECD published specific guidance in December 2020 addressing comparability adjustments, loss allocation, government assistance, and the treatment of exceptional costs. That guidance remains a useful reference for the analytical principles it established, particularly around the importance of contemporaneous documentation and the framework for allocating extraordinary costs within a group.

However, the current situation differs from COVID in ways that make the transfer pricing analysis, in some respects, more difficult. COVID was a global, demand-side shock. Markets everywhere were affected, which meant that comparables were equally distorted and adjustments could be applied across the board with some confidence that the underlying distortion was universal. The immediate disruption is regional and primarily supply-side. Businesses in the Middle East have demand but cannot physically deliver because supply chains have been severed. Meanwhile, businesses operating in unaffected regions are performing relatively normally (notwithstanding the increased uncertainty arising from volatility in natural resource costs). This creates a comparability problem that COVID did not: the performance of a Middle Eastern distributor that has lost 40 percent of its margin due to rerouting costs looks anomalous against a set of European or Asian comparables that are operating with relatively lesser disruption.

This asymmetry has practical consequences. Tax authorities reviewing transfer pricing outcomes for the current period will see regional entities posting results that deviate significantly from benchmarks derived from unaffected markets, with a marked difference to comparable company financial data, which is often based on financial statements issued in prior periods. The burden of explaining why those results are nevertheless arm's length falls on the taxpayer, and that explanation must be supported by contemporaneous evidence of what happened, what decisions were made, and why the pricing was adjusted. The OECD's COVID-era principles around documentation and contemporaneous analysis apply in full, but the factual context in which they must be applied is materially different.



Supply chain disruption and intercompany pricing

The most immediate transfer pricing pressure is arising from the physical rerouting of supply chains. Where goods previously flowed through established maritime corridors to hub entities in the Gulf, they are now being routed through alternative ports, transported by land across borders, or shipped via extended sea routes. Each of these alternatives carries significantly higher costs: additional freight charges, deviation surcharges imposed by carriers, bonded warehousing at alternative entry points, land transportation across jurisdictions, and, in many cases, duplicate customs duties where goods enter one country before being moved to their final destination.

For groups that have characterized their regional entities as limited risk distributors, commissionaires, or similar low-risk/low-return structures, the question is whether those entities should be absorbing these extraordinary costs or if the costs should be borne by the principal. The answer depends on the contractual arrangements, the actual conduct of the parties, and the allocation of risk. If the regional entity bears no supply chain risk under the intercompany agreement, then absorbing extraordinary logistics costs is inconsistent with its functional profile and the principal should be compensating it or bearing the costs directly. If the entity does bear some supply chain risk but the current costs are far beyond what was contemplated when the pricing was set, the question becomes whether the existing pricing mechanism has a cost pass-through provision or if an adjustment is needed.

These are not abstract questions. A distributor that reports a significant loss because it absorbed extraordinary costs that should have been borne by the principal is creating a transfer pricing exposure in the jurisdiction where it is located. Equally, a principal that continues to extract its normal return while the distributor absorbs all the disruption risk is creating a different kind of exposure, one that may attract scrutiny from the principal's tax authority. The arm's length outcome under current conditions may look very different from the arm's length outcome under normal conditions. That is acceptable, provided it is properly analyzed and documented.



Loss allocation and the arm's length principle

One of the most sensitive transfer pricing issues arising from any period of disruption is the allocation of losses within a multinational group. The fundamental question is which entity should bear the losses, and why.

The OECD Transfer Pricing Guidelines are clear that limited risk entities can, in principle, incur losses in exceptional circumstances. The COVID guidance reinforced this point, noting that even a low-risk entity may suffer short-term losses during a period of severe disruption if an independent party in comparable circumstances would also have incurred a loss. However, sustained or disproportionate losses in a limited risk entity will attract scrutiny, because they are inconsistent with the risk profile that justified the entity's low return in the first place.

In the current environment, businesses need to consider several dimensions. First, has the functional profile of the regional entity actually changed? If a distributor that previously performed routine functions is now managing complex logistics, negotiating with alternative suppliers, and making operational decisions that it would not normally make, its functional profile has shifted upward. That shift should be reflected in the pricing, potentially through a higher return in recognition of the enhanced functions. Second, are the losses attributable to risks that the entity was allocated under the intercompany agreement, or are they the result of risks that were always borne by the principal? The answer determines who should bear the loss. Third, how would independent parties have dealt with the situation? Would an independent distributor have absorbed all of these costs, or would it have renegotiated the supply terms with its supplier?

Getting the loss allocation wrong has consequences in both directions. Over-allocating losses to the regional entity may result in a challenge from the local tax authority. Under-allocating losses to the regional entity by artificially maintaining its guaranteed margin, while the group absorbs the costs elsewhere, may result in a challenge from the principal's tax authority. The arm's length answer lies in the specific facts, and it must be documented contemporaneously.



Permanent establishment risk and profit attribution

The relocation of key personnel from the Gulf to other jurisdictions creates permanent establishment risk that has a direct transfer pricing dimension. Where a PE is found to exist, profits must be attributed to it on an arm's length basis under the authorized OECD approach, treating the PE as if it were a separate and independent enterprise.

The profit attribution analysis depends on the functions performed, assets used, and risks assumed at the PE location. If a senior executive who previously directed the regional business from Dubai is now performing the same functions from London, Amman, or Cairo, the question is not only whether a PE exists but how much profit should be attributed to it. The more significant the functions relocated, the greater the profit attribution. For a regional headquarters entity whose value derives primarily from the management and coordination functions performed by its senior personnel, the relocation of those personnel can fundamentally alter the economic substance of the entity and, by extension, the transfer pricing model that supports it.

Businesses should be mapping the location and functions of all personnel whose activities could give rise to PE risk, documenting the temporary and crisis-driven nature of the relocation, and modelling the potential profit attribution consequences. Where the relocation is genuinely temporary and the personnel will return when conditions allow, the OECD commentary suggests that tax authorities should take a pragmatic view. However, pragmatism depends on documentation, and the burden of demonstrating that the relocation was temporary falls on the taxpayer.





Intercompany financing under stress

The situation is placing significant liquidity pressure on regional entities. In many groups, the response has been for the group treasury or parent company to extend additional intercompany credit lines, defer receivable collections, or inject emergency cash to keep regional operations functioning. Each of these actions has transfer pricing implications.

Intercompany loans extended during a crisis should still be priced on arm's length terms, but the question of what constitutes arm's length pricing for a loan to a borrower operating in a conflict-affected region is not straightforward. The credit risk of the borrower has changed. The risk premium that an independent lender would charge for exposure to the region has increased materially. If the intercompany loan is priced at the same rate that applied before the disruption, the question remains whether an independent lender would have maintained those terms, and the answer in most cases is that it would not.

Equally, where a parent company defers collection of intercompany receivables to ease liquidity pressure on the regional entity, the deferral may need to be characterized and priced as an implicit loan. The failure to charge interest on overdue intercompany balances is one of the most common transfer pricing adjustments made by tax authorities, and the current environment, where deferrals may extend for months, increases the exposure.



Management fees and intercompany services

The disruption raises questions about the continued appropriateness of management fee and intercompany service charges. If a regional entity is paying a management fee to a parent or regional headquarters entity for services that include, for example, supply chain management, logistics coordination, and market development, the question is if those services are still being provided at the same level and in the same form. If the supply chain is broken and the headquarters is unable to deliver the coordination services that justified the fee, the regional entity is paying for a service it is not receiving. An independent party would renegotiate or suspend the fee.

Conversely, some headquarters functions may have intensified during the crisis. Crisis management, alternative sourcing, government relations, and employee support services may be consuming significantly more resources than under normal conditions. If these services are being provided to regional entities but are not reflected in the intercompany charging mechanism, the headquarters entity would be providing value for which it is not being compensated.

The key principle is that the service charges should reflect the actual services provided during the disruption period, not the services that were envisaged when the intercompany agreement was signed. Where the nature, scope, or intensity of services has changed, the pricing should be adjusted to reflect the actual position. As with all other adjustments, this should be documented contemporaneously with a clear rationale linking the pricing change to the change in the underlying service.





Advance pricing agreements and rulings

Businesses with APAs in place face a particular challenge. An APA is premised on a set of critical assumptions about the business, its operations, and the economic environment in which it operates. Where those assumptions no longer hold, the APA may not be capable of producing an arm's length outcome. As a result, the taxpayer must choose between applying the APA mechanically, potentially leading to an indefensible result, or deviating from it and risking a non-compliance challenge.

Most APA frameworks, including those operated by the tax authorities in Saudi Arabia and the UAE, contemplate a mechanism for consultation or revision in the event of material changes in circumstances. The current disruption almost certainly qualifies as a material change. The critical step is to engage with the relevant tax authority proactively and transparently, before the filing deadline, to discuss whether the APA terms can be adjusted for the disruption period or whether they should be suspended. Tax authorities are far more receptive to a taxpayer who comes forward early and explains the situation than to one who files a return that deviates from the APA without prior consultation.

Businesses should be reviewing their APAs now to assess which critical assumptions have been affected, preparing a factual summary of the impact on the covered transactions, and initiating contact with the tax authority at the earliest opportunity.



Documentation: The non-negotiable discipline

If there is a single message that runs through every dimension of this article, it is that contemporaneous documentation is essential. Transfer pricing disputes are won or lost on documentation, and the documentation that matters most is the one that is prepared at the time the decisions are made, not the one that is reconstructed months later for the purpose of a filing or an audit.

Businesses should be creating a contemporaneous record of the disruption's impact on their intercompany transactions. This record should include the following:

The decisions made in response (including rerouting, cost allocation, personnel relocation, and pricing adjustments)

A factual description of the disruption and its operational consequences

The decisions made in response (including rerouting, cost allocation, personnel relocation, and pricing adjustments)

The arm's length rationale for each decision

Any communications with group entities about changes to intercompany terms

Any engagement with tax authorities regarding APAs or rulings

This documentation does not need to be elaborate. It needs to be contemporaneous, factual, and internally consistent. A well-prepared record created in real time is significantly more persuasive than a sophisticated analysis prepared retrospectively.

Transfer pricing across the region: Key jurisdictional considerations

The transfer pricing regulatory landscape across the Middle East is not uniform, and the implications of the current disruption must be assessed against the specific rules and enforcement posture of each jurisdiction.



Saudi Arabia has the most mature and actively enforced transfer pricing regime in the region. The Zakat, Tax and Customs Authority (ZATCA) requires transfer pricing documentation in line with the OECD three-tiered approach, including a local file and master file. Penalties for non-compliance are significant, and enforcement activity has increased materially in recent years. Businesses with APAs in Saudi Arabia should be prioritizing engagement with the ZATCA to discuss the impact of the disruption on covered transactions. The ZATCA has demonstrated willingness to engage in constructive dialogue where taxpayers approach them proactively and transparently.



United Arab Emirates introduced transfer pricing rules as part of the corporate tax regime that took effect in 2023. The regulations require arm's length pricing for related party and connected person transactions, with documentation obligations that broadly follow the OECD framework. For many businesses in the UAE, this will be the first period in which transfer pricing compliance intersects with a significant operational disruption. The documentation prepared now will set the precedent for how the business's transfer pricing is assessed in future periods. Getting it right from the outset is critical.



Egypt has well-established transfer pricing rules and an increasingly active enforcement posture. The Egyptian Tax Authority has been building its transfer pricing audit capacity and has demonstrated willingness to make substantial adjustments. For businesses with Egyptian operations that are now absorbing rerouted goods or relocated personnel, the transfer pricing implications in Egypt should be assessed independently against Egyptian rules, which have their own specific requirements around documentation, benchmarking, and the treatment of related party transactions.



Qatar, Kuwait, Bahrain, and Oman have transfer pricing provisions at varying stages of maturity. Qatar's income tax law includes transfer pricing provisions, and the General Tax Authority has been increasing its scrutiny of related party transactions. Kuwait's tax framework applies primarily to foreign corporate bodies and includes provisions around arm's length pricing. Bahrain's corporate tax, introduced recently, incorporates transfer pricing principles. Oman has transfer pricing provisions within its income tax law and has been developing its enforcement capacity. While the enforcement intensity in these jurisdictions has historically been lower than in Saudi Arabia or Egypt, businesses should not assume that transfer pricing positions taken during a period of disruption will not be scrutinized. The regulatory trajectory across all of these jurisdictions is toward increased enforcement, and the documentation created now will be the evidence assessed in future audits.



Jordan and Lebanon present different considerations. Jordan has transfer pricing provisions and an active tax authority that engages with multinational taxpayers. For businesses with operations or personnel that have relocated to Jordan, the transfer pricing implications should be assessed against Jordanian rules. Lebanon's situation is complicated by the direct impact of the conflict on its territory and infrastructure, and businesses with Lebanese operations face a distinct set of challenges around operational continuity, documentation, and compliance that require specific advice.



Acting now, not later

The temptation in a period of uncertainty is to defer transfer pricing considerations until the situation stabilizes, and focus instead on operational priorities. That instinct is understandable but carries real risk:

Transfer pricing adjustments made retrospectively are inherently less credible than those made in real time.

Documentation prepared months after the event lacks the contemporaneous quality that tax authorities expect.

APAs that are allowed to lapse without consultation may be treated as breached rather than suspended.

Intercompany arrangements that continue to operate on pre-disruption terms despite fundamental changes in the underlying economics create exposures in multiple jurisdictions simultaneously.

The arm's length principle does not suspend itself during a crisis. If anything, it becomes more important, because the range of defensible outcomes widens and the need to demonstrate that the outcome selected falls within that range becomes more acute. Businesses that invest the time now to analyze, adjust, and document their transfer pricing positions will be in a materially stronger position when the audit cycle reaches the current period.



How Deloitte can help

Deloitte's Transfer Pricing practice in the Middle East is the largest and most established in the region, with dedicated transfer pricing professionals across the Gulf, the Levant, and North Africa. We advise multinational businesses on the full spectrum of transfer pricing matters, from policy design and documentation through to dispute resolution and advance pricing agreements.

We are actively supporting clients in assessing the transfer pricing implications of the current disruption, including real-time policy recalibration, contemporaneous documentation, loss allocation analysis, APA consultation support, and PE risk modeling. This article forms part of a broader series of client-facing thought leadership and webinars covering the tax and legal implications of the current regional disruption. For further information or to discuss your specific circumstances, please contact any of the authors below or your usual Deloitte Transfer Pricing contact.

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