

Saudi Arabia publishes draft transfer pricing by-laws

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In brief

The General Authority of Zakat and Tax (GAZT) in the Kingdom of Saudi Arabia (KSA) published on December 10, 2018, its draft Transfer Pricing By-Laws (the draft By-Laws).

This is the first time that transfer pricing (TP) regulations of any kind have been published by the GAZT and demonstrates the KSA's commitment to introducing TP rules and implementing the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) recommendations on TP.

Specifically, the draft By-Laws introduce requirements for the OECD's three-tiers of documentation — namely Master File, Local File and Country-by-Country (CbC) report — as well as an annual Disclosure Form for controlled transactions.

This Tax Insight provides some background to the TP landscape in the KSA and takes a detailed look at the provisions of the draft TP By-Laws. For a quick look at the substance of the proposed rules, please see our news alert [here](#). A link to the draft By-Laws can be found [here](#).

In detail

Background

Transfer pricing in the KSA to-date

Prior to the publication of the draft By-Laws, the KSA tax law contained no detailed TP rules or guidelines. However, transactions between related parties and the arm's-length principle (ALP) are explicitly addressed in the Income Tax Law (the law).

More specifically, Article 63(c) of the law provides that the GAZT may re-allocate revenues and expenses in transactions between related parties to reflect the returns that would have resulted if the parties were independent or unrelated.

Article 64 defines related parties using the term 'common control.' Companies and organisations are considered to be under common control if they are 50% or more controlled by the same related person(s), where control is defined as

ownership of rights to income or capital, voting rights or value, or other beneficial interest either directly or indirectly through one or more subsidiaries of any type of companies.

Article 58 requires taxpayers, other than a non-resident party with no permanent establishment (PE) in KSA, to maintain documentation (in Arabic) to support the 'precise determination of tax payable' by them. Moreover, Article 61 provides the GAZT with

authority to examine a taxpayer's records.

Observation: Taken together, these articles currently provide the GAZT with the authority to request underlying documentation and to make income adjustments based on the ALP.

Article 10 (11) of the draft By-Laws includes provision for the GAZT to issue rules for determining the 'fair value' of transactions among related parties in accordance with generally accepted international standards i.e., the draft By-Laws to which this Tax Insight relates.

Payments for goods or services delivered to the taxpayer by related parties, to the extent that they are in excess of an arm's-length value, are considered non-deductible from a KSA perspective.

OECD BEPS project

The OECD embarked upon a 15-point BEPS Action Plan in 2013, providing recommendations to increase coherency, reinforce the requirement for economic substance, and enhance transparency within the international tax system.

The work on Action 13, titled "Transfer Pricing Documentation and Country-by-Country Reporting" (Action 13), formalized the three-tiered approach to TP documentation. The OECD Transfer Pricing Guidelines (OECD Guidelines) were updated in 2017 to reflect this approach.

In 2016, the OECD established an 'Inclusive Framework' for monitoring the implementation of the BEPS project recommendations, enabling non-OECD countries the opportunity to participate on an equal footing.

Observation: As an Inclusive Framework member, the KSA has agreed to the implementation of four

minimum standards of the BEPS project, including Action 13. The draft By-Laws therefore reflect the KSA's commitment under the Inclusive Framework to implement the recommendations of the BEPS project.

What do the draft By-Laws say?

Introduction and effective date

The publication of the draft By-Laws represent a major step forward in formalizing TP requirements within the KSA.

The final version of the By-Laws will be effective from the date of their future publication, and will apply prospectively to controlled transactions to which taxpayers are a party during the fiscal year ending 31 December 2018 onward.

Notwithstanding this, the GAZT will have the right to request information about all controlled transactions to which the By-Laws apply, retrospectively, regardless of the date of those transactions.

Scope of the rules

Article 2 of the draft By-Laws confirms that, unless otherwise stated, they apply to "all Taxable Persons under the Law."

The 'Law' means the Income Tax Law issued by Royal Decree No. (M/1) dated 15/1/1425H and its amendments. This is the corporate Income Tax Law in the KSA.

'Taxable Person' (hereafter taxpayers) is defined as a 'Person' subject to tax as per the Law: A 'Person' is defined as a natural person or juridical person (i.e., a non-natural person recognised by law or fact to have legal personality, including PE's).

Further, as discussed below, there is the possibility for the principles contained within the draft By-Laws to

extend to Zakat payers in certain circumstances.

Controlled transactions and related definitions

The draft By-Laws define 'controlled transactions' as those involving 'Related Persons' or 'Persons Under Common Control,' and specifically include notional transactions or consideration exchanged with PE's.

'Related Persons' and 'Persons Under Common Control' are widely defined in the draft By-Laws, dependent in part on the definition of 'Effective Control' which also is broadly drafted. The Related Persons definition covers three scenarios:

- two or more natural persons are related:
 - either through marriage or otherwise related to the fourth degree, or
 - by being partners in a partnership.
- a natural person (and related persons) is related to a juridical person:
 - through control of 50% or more over voting rights, income, or capital
 - if they are a beneficiary or capable of benefiting from a trust, or
 - if they participate or are able to participate in the management, control, or capital of that juridical person.
- two or more juridical persons are related:
 - if they are 'Persons Under Common Control,' or
 - if one or more juridical persons have 'Effective Control' over one or more other juridical persons

Focusing on the third scenario, two or more juridical persons are 'Persons Under Common Control' if a person (including related persons) either:

- controls 50% or more of the juridical persons, by way of rights to capital or income of the partnership or company, or 50% or more of the rights to, or beneficial interest in, the income or assets of a trust, or
- is able to control the business decisions of, or otherwise has 'Effective Control' over, the juridical persons.

'Effective Control' is in turn defined as the "ability of a Person to control the business decisions of another Person." The draft By-Laws set out 11 circumstances in which effective control can be achieved, including:

- the ability to conclude agreements to provide, or effectively performing, management functions
- the ability to control the composition of 50% or more of the board of directors
- the provision of loans, the total outstanding balance of which is 50% or more of the funds necessary for the borrower's business
- the issue of guarantees covering 25% or more of the total borrowings of a Person

Observation: While the draft By-Laws state '25% or less,' we expect that the intent is to have issued guarantees of 25% or more to demonstrate effective control.

- circumstances where 50% or more of a Person's business activities depend on transactions with the Person (who is

considered to have Effective Control)

- being a principal or supplier of a Person under an exclusive agency, distributorship arrangement, or other similar contract for the sale of goods, services, or rights, with the effect that the Person is a dependent agent of the principal, and is prohibited from entering into similar arrangements
- where a substantial portion of the business activities of a KSA resident Person depends on transactions with, and rights in intangible property granted on an exclusive basis by, a non-resident Person, and
- having control over the business decisions of a Person in any other way, as evidenced by the facts and circumstances.

In all cases, control can be exercised by a person alone, or jointly with related persons, either directly or indirectly.

Observation: The effect of these three main terms ('Related Persons,' 'Persons Under Common Control,' and 'Effective Control') is to potentially set a low bar for transactions to be deemed controlled transactions and hence be captured by the draft By-Laws.

Arm's-Length Principle (ALP)

The definition of the ALP contained within the draft By-Laws is broadly consistent with that enshrined in Article 9 paragraph 1 of the OECD's Model Tax Convention on Income and Capital.

As per Article 3, the GAZT expects persons engaged in controlled transactions to conduct those on an arm's-length basis.

The GAZT also requires the tax base of a PE in the KSA to be determined according to the arm's-length principle. This represents a step toward consistency with the Authorised OECD Approach (AOA) for the attribution of profits to PE's.

Article 4 of the draft By-Laws requires that adjustments should be made by taxpayers to their tax base, where their controlled transactions are not conducted on an arm's-length basis.

The GAZT will determine whether controlled transactions are conducted at arm's length. If the terms, conditions, or remuneration of controlled transactions do not reflect an arm's-length basis, then the GAZT either may direct that the tax base be adjusted or reallocate and re-characterize revenue and expenses arising from the controlled transaction to reflect the arm's-length result.

Observation: While the draft By-Laws actually state that the GAZT may 're-categorize' revenue and expenses, we understand the intention is to re-characterise these.

Comparability

Article 3 also introduces the concept of comparability by providing that an arm's-length basis is achieved if the terms of the controlled transaction are materially similar to the terms of a comparable transaction between independent persons.

The comparability of transactions is expanded upon in Article 5, and includes reference to the five comparability factors described in the OECD Guidelines. **Observation:** The draft By-Laws include a sixth factor not in the OECD Guidelines – any other economically relevant aspect of the transaction – which should impress upon taxpayers the need to consider the full facts and circumstances of the transaction.

Article 13 of the draft By-Laws confirms that neither taxpayers nor the GAZT may rely on comparable information that is not, or could not be made, available to either party.

In addition, the Article makes it clear that foreign comparables may be used in the event that domestic (KSA) comparables are not available. However, taxpayers must be able to demonstrate that those comparables are consistent with the requirements of the By-Laws and take into account the expected impact of geographic differences and other factors (e.g., price and profitability).

TP methods

Articles 6 to 10 of the draft By-Laws approve the use of the five OECD TP methods without prescribing a preference for the order in which they should be used. These are:

- The Comparable Uncontrolled Price Method (CUP)
- The Resale Price Method (RPM)
- The Cost Plus Method (CPM)
- The Transaction Net Margin Method (TNMM)
- The Transactional Profit Split Method (PSM).

In line with the OECD Guidelines, the most appropriate method should be used, being the one that under the facts and circumstances provides the most reliable measure of an arm's-length result.

The draft By-Laws state that it is "not necessary to apply more than one method" for a given controlled transaction. However, the description of the PSM allows for some functions of a controlled transaction to be priced using one of the approved methods, and the PSM applied to the resulting common residual profit.

Aside from the approved methods, other methods can be used if the taxpayer can demonstrate that none of the approved methods provides a reliable measure of the arm's-length result.

Finally, the draft By-Laws allow for aggregation of controlled transactions during analysis of the arm's-length price where they are economically closely linked or form a continuum such that they cannot reliably be analyzed separately.

Arm's-length range

The draft By-Laws currently define the arm's-length range of results as a 'range of acceptable arm's length' results, without reference to a statistical measure (e.g., an inter-quartile range). The GAZT is expected to include in any future Guidelines rules relating to the selection of a point within the arm's-length range.

The GAZT will not make adjustments to a controlled transaction where the relevant financial indicator derived from the transaction and tested under the appropriate method above falls within the arm's-length range. As expected though, they may adjust any which fall outside the arm's-length range.

Corresponding adjustments

The draft By-Laws provide for the possibility for the GAZT to make corresponding adjustments to the tax base of a KSA taxpayer, to relieve economic double taxation in certain circumstances.

Where the KSA taxpayer has entered into controlled transactions with a non-resident and an adjustment has been made by the overseas tax authority, the GAZT will examine the consistency of that adjustment. If it agrees that the adjustment is consistent with the ALP (both in principle and as regards the amount), it will make a corresponding

adjustment to the tax base of the KSA taxpayer.

However, if the GAZT concludes that the adjustment made by the overseas tax authority is not appropriate, it will communicate with that authority in accordance with the Mutual Agreement Procedures (MAP) included within the relevant double tax treaty with that country.

The onus is on the taxpayer to apply to the GAZT for a corresponding adjustment, disclosing all required facts and circumstances substantiating the application. However, no guidance currently has been included regarding the time limit for applying, the form the application should take, or a list of the types of information that should be supplied by the taxpayer.

Ultimately, the GAZT may reject an application to make corresponding adjustments if:

- the arrangement is considered artificial or abusive, and to which Article 63(a) (anti-avoidance procedures) of the Law applies (or the GAZT determines it may apply), or
- a final decision has been made in respect of the taxpayer's claim by the competent judicial body, and that decision is not appealable.

Documentation

The draft By-Laws require every taxpayer that is party to a controlled transaction to keep documentation required to confirm the conditions of the transactions are arm's length, subject to some exceptions.

Articles 15 to 19 set out the documentation requirements. They follow those outlined by the recommendations of Action 13 of the OECD's BEPS Project, namely:

- Master File

- Local File, and
- CbC report.

They also confirm the right of the GAZT to request “any information related to the controlled transactions that it deems necessary to carry out its regulatory functions and other duties.”

In addition, Article 14 introduces a new mandatory documentation filing requirement. It requires taxpayers to submit a ‘Disclosure Form of the Controlled Transactions’ to the GAZT together with their annual income tax declaration within 120 days of the end of the fiscal year.

Documentation must be readily accessible and available for review by the tax authority at the time of submission of the Disclosure Form, and contain information and economic analysis to verify that the conditions of the controlled transactions are at arm’s length.

The Disclosure Form also requires confirmation of whether the Taxable Person maintains a transfer pricing Master File and Local File.

Observation: The implied effect of this requirement therefore is to require that Master File and Local File documentation is prepared within 120 days of the end of the fiscal year.

The draft By-Laws state that documentation shall be provided to the GAZT within 30 days of request.

Observation: We understand that this is most likely to apply to the Master File, as the Disclosure Form and CbC report have their own filing deadlines, and the Local File must be submitted to the GAZT within seven days of request.

Disclosure form

The GAZT stipulates the following 10 pieces of information that must be included in the Disclosure Form:

- names of the related parties to the controlled transactions and the countries in which they are resident / established
- group / taxpayer business restructuring information
- names of the legal and beneficial owners of the taxpayer, as well as percentage ownership and the countries they are resident / established
- total revenue, total expenses, and the net profit/loss reported in the annual income tax declaration for the year
- details of the type and nature of the relationships among the related parties to the controlled transactions
- a description of the nature of the business activities of the related parties and of the controlled transactions
- transaction information, including aggregate consideration, and the nature of receipt (income) or payment (expense)
- the transfer pricing method applied by the taxpayer
- a statement certifying whether the taxpayer has entered in to controlled transactions by way of barter or trade (i.e., without consideration or monetary consideration being exchange), and details of such transactions (e.g., fair market value of the barter / trade)
- confirmation of whether TP documentation is maintained (including Master File and Local File).

The GAZT has confirmed that it may raise additional questions to taxpayers

by way of questionnaires “or any other such form that [it] sets”.

Observation: The draft By-Laws do not currently state explicitly whether the Disclosure Form must be prepared and submitted by all taxpayers or only those with controlled transactions.

Master File and Local File

The Master File and Local File requirements in Articles 16 and 17, respectively, broadly follow those outlined by the recommendations of Action 13 of the OECD’s BEPS Project. Accordingly, this Insight does detail the specific information to be included in these files.

Observation: As mentioned above, our understanding is that these documents should be readily accessible and available for review by the tax authority at the time of submission of the Disclosure Form.

The Master File will need to be provided to the GAZT within 30 days of request. Article 17 confirms that the Local File will need to be provided to the GAZT within seven days of request (or within any other time limit specified by the GAZT in the request, being not less than seven days).

Country-by-country (CbC) reporting

In respect of CbC reporting, the draft By-Laws set out the circumstances in which the Ultimate Parent Entity (UPE) of an MNE Group, or a Taxable Person in the Kingdom that is not an UPE, will need to submit and file reports and notifications to the GAZT, and state that these will need to be in the language and form that the GAZT may specify.

The requirements are broadly in line with the recommendations of Action 13 of the OECD’s BEPS Project. Accordingly, this Insight does not detail the requirements, except to point out that:

- the threshold for companies to be subject to the report filing and notification requirements is a consolidated group revenue exceeding 3.2 billion Saudi Riyals (c. €750m)
- the CbC report must be filed within 12 months after the last day of the year to which the report relates, and
- the notification submission deadline is 120 days following the end of the reporting year.

The draft By-Laws currently do not specify from which year onward the consolidated group revenue threshold applies.

Documentation — deadlines and thresholds

Disclosure Form – to be submitted within 120 days following the end of the fiscal year

Local File – requirements effective 31 December 2018; implied deadline of 120 days following the end of the fiscal year; to be submitted in as little as seven days upon request by GAZT

Master File – requirements effective 31 December 2018; implied deadline of 120 days following the end of the fiscal year; to be made available within 30 days upon request by GAZT

CbC notification – to submit within 120 days of the year-end to which the CbC report relates

CbC report – to file within 12 months of the year-end to which the report relates. The first report should be prepared for the group's fiscal year ending 31 December 2018. Applies to groups with consolidated group revenue exceeding SAR 3.2bn (c. €750m)

Exceptions to documentation requirements

Article 19 outlines exceptions to the Master File and Local File requirements, which are broadly available to:

- natural persons
- taxpayers that do not enter in to controlled transactions, and
- “small enterprises” with controlled transactions the arm's-length value of which do not exceed 6m Saudi Riyals (c. €1.4m) during any 12-month period.

Observation: These exceptions, and particularly the *de minimis* threshold, are a useful inclusion in the draft By-Laws and demonstrate a pragmatic approach by the GAZT.

Notwithstanding these exceptions, the GAZT has included a provision to require any person to prepare and maintain documentation related to controlled transactions, and to provide this documentation within 30 days of request. This provision is exercisable at the GAZT's discretion, in any of the following circumstances:

- where controlled transactions are entered in to with Persons deemed to be resident in the KSA, or established in special economic zones situated in the KSA

Note: The definition of ‘Person’ as described earlier is wider than that of a ‘Taxable Person’ under the draft By-Laws (e.g., could be interpreted to include a Zakat payer).

- where controlled transactions are entered in to with persons that are legally granted any exemption or relief from tax or Zakat obligations, or both, in the KSA
- where the GAZT has reason to believe that any of the

circumstances covered in Article 63(a) (anti-avoidance procedures) of the Income Tax Law exist

- where a person has submitted a request to the GAZT for a corresponding adjustment to be made.

Observation: As referenced earlier, while the draft By-Laws are aimed at corporate Income Tax payers in the KSA, there seemingly is the possibility that the principles also may apply to controlled transactions entered in to with persons who benefit from an exemption or relief from KSA Zakat or tax (or both). Further clarification on this point is needed, to understand exactly the intended reach of the draft By-Laws.

Penalties

The draft By-Laws do not specifically provide for penalties for non-compliance, and / or penalties resulting from transfer pricing adjustments made by the GAZT.

Observation: We expect that the current ‘monetary’ and ‘non-monetary’ penalty provisions of the law will apply in such situations, until or unless further clarification is provided by the GAZT on this matter.

Future work

Guidelines

Article 24 states that the GAZT may publish guidelines on the (final) By-Laws, containing guidance on the selection of suitable TP methods and any other TP related matters.

These Guidelines are also referenced in the definitions in Article 1, as well as Articles 7, 11, 13, 14, 18, and 23. If published, they also may include guidance on the interpretation, implementation, enforcement, and application of the rules.

The takeaway

While still in draft, this publication is a landmark moment in the development of tax law in the KSA. The By-Laws reflect a positive approach to transfer pricing by the GAZT, consistent with OECD principles, and in our view

represent a fair and transparent step toward the implementation of TP rules.

There are some areas where further clarification is needed, but this is to be expected given this is a first-draft document.

In light of the wide application of the rules as currently drafted, taxpayers should to take a detailed look at their business operations to identify TP issues and seek to comply with the upcoming requirements.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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