Transfer pricing documentation in the Middle East: A critical necessity?

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In brief

When entities in multinational groups provide goods, services, intellectual property, financing, and other benefits to each other, transfer pricing (TP) is the internal price charged for these benefits. That impacts the level of profits/losses booked in a group's local financial statements and hence affects the absolute level of corporate tax payable by a group. That also impacts the level of transactional taxes these companies pay, e.g., withholding taxes, and indirect taxes, e.g., Value Added Tax (VAT).

TP documentation refers to the package of documentation that businesses need to assemble to support their transfer pricing arrangements to tax authorities. For businesses operating in the Middle East, is putting into place this documentation a critical necessity? A cost-benefit analysis strongly suggests that for multinationals operating in the Middle East, there is a net benefit in preparing and maintaining a TP Masterfile and TP local files on a selective basis.

In detail

As a means of guiding global tax authorities and corporate taxpayers to prevent tax Base Erosion and Profit Shifting (BEPS) through TP and other means, a package of measures (15 actions) was published by the Organisation for Economic Co-operation and Development (OECD) in 2015.

One of the most talked about actions in the BEPS package is Action 13, which relates to TP documentation. In addition to the requirement for large multinational groups to prepare a country-by-country (CbC) data report, guidance also was given by the OECD on the need for multinational groups to prepare a global TP Masterfile and TP local files in the key territories in which they operate.

For many global multinationals operating in the Middle East, headquartered inside and outside the region, this has raised a number of questions about the need to prepare TP documentation for Middle East operations. Given that Middle East countries are not OECD members, businesses headquartered in the region often consider whether TP documentation should be prepared for any countries in the Middle East, just as they prepare TP documentation for countries where they operate that are OECD members or otherwise have TP rules. Similarly, businesses headquartered outside the region consider whether preparing TP local files for Middle East countries is necessary or advisable.

Similar to the laws in many OECD countries, domestic tax provisions in many Middle East countries put the onus on taxpayers to demonstrate that local profit outcomes are arm's length. While generally there are no formal TP documentation requirements (except in Egypt), the ambiguity of the laws, the lack of OECD and UN references in law, and little local direction on acceptable TP methods potentially make it possible for Middle East tax authorities to exercise a greater level of discretion with respect to companies that have not prepared a basis for their TP policies.

For multinationals headquartered outside the region in particular, making references to either global or regional policies and documentation can be unproductive because local tax inspectors may view those as having no bearing on their local market and hence not relevant to them. Local audit experience also suggests that global or regional reports — and in particular, global comparables (data sets used to support TP results) — can exacerbate tax adjustment risk and in some cases lead to arbitrary penalties (if the tax authorities insist that there has been an underpayment of tax).

In some cases, preparing local TP files only upon audit also can be counterproductive because tax authorities in the region may take the opportunity of delay to raise more questions — very often on issues that run parallel to TP issues, e.g., on permanent establishments (PEs). In some cases, delays in providing information to tax authorities upon audit can make tax authorities more skeptical about the overall level of profit booked locally.

In other cases, when TP documentation is prepared only upon audit, such recent documentation may be dismissed as having 'no relevance' if the transactions under audit were years ago. Even if it is argued that the data contained in the recently prepared TP documentation relates to the time period of the transactions, this still may be disregarded simply because the file had been prepared after commencement of the audit.

Another disadvantage to responding to an audit by preparing TP documentation instead of being proactive is that data can become lost and personnel relevant to years in question can move on, with an adverse effect on the quality of information available in responding to the case.

Some groups consider whether in addition to a Masterfile, a regional file should be prepared for the Middle East instead of local TP files for specific Middle East countries. One potential disadvantage to producing a regional report is that for a given audit, the local tax authority in question also has access to data (including profit margins) made by other operating companies in the region, which provides a comparator to that tax authority to argue for more profits to be taxed in its country on the basis that other companies in the region make more.

Even if profit margin data is excluded in a regional report, it still draws attention to the group's other operating companies in the region. Questions may be asked about what they do, how comparable they are to what the company being audited does, and why the company being audited does not make more profit. In any case, local tax inspectors expect detail on the company being audited and local market circumstances, so combining information into one regional report may not provide significant efficiencies.

So what does this mean for multinational businesses operating in the Middle East? What is the best way to manage tax risk, yet also to be efficient and pragmatic?
Many multinational businesses operating in the region with material intra-group transactions at least prepare a TP Masterfile. With the introduction of Value Added Tax (VAT) in the Gulf Cooperation Council (GCC) countries, many of these businesses have found that preparation of a TP Masterfile has served them in helping map intra-group transactions for VAT purposes.

Many multinational businesses also prepare local TP files on a selective basis. For a country like Egypt, which has a comprehensive TP regime and where annual local TP documentation is mandatory, businesses routinely prepare local TP files. For other countries that have a corporate tax regime and provisions in their local tax laws on intra-group transactions, multinational businesses also commonly prepare local TP files. These include countries such as Jordan, the Kingdom of Saudi Arabia (KSA), Kuwait, Lebanon, Oman, and Qatar. For countries that do not yet have a corporate tax regime, e.g., the United Arab Emirates (UAE) and Bahrain, local TP files would yield limited benefit; accordingly, preparation of local TP files for these countries may not be advisable.

TP rules and documentation requirements in certain Middle East countries

Country	TP rules apply to intra-group transactions	TP rules adhere to arm's-length principle	Statutory TP documentation requirements	Preparation of local TP documentation recommended
Bahrain				
Egypt	✓	✓	✓	✓
Jordan	✓	✓		✓
KSA	✓	✓		✓
Kuwait	✓	✓		✓
Lebanon	✓	✓		✓
Oman	✓	✓		✓
Qatar	✓	✓		✓
UAE				

The takeaway

In summary, given the above discussion, a cost-benefit analysis for multinationals operating in the Middle East strongly suggests a net benefit in preparing and maintaining a TP Masterfile and TP local files on a selective basis.

While most, if not all, Middle East countries are not OECD members, the OECD BEPS project has generated considerable interest from the tax authorities of a number of countries in the region. For example, while Egypt is not an OECD member, its TP Guidelines follow OECD principles; also, KSA is a G20 country, which is a co-sponsor of the BEPS project. Both these countries and others in the region are actively considering the impact of BEPS on local domestic tax legislation and practice. It also is clear that in some Middle East countries, some of the longest tax and TP-related audits in some cases can last for many months and even years.

Commencing discussions with tax authorities by providing a Masterfile and local TP documentation — containing most of what the tax authorities usually ask for — may significantly lessen protracted discussion and correspondence. A good opening dialogue with tax inspectors — involving robust TP documentation that focuses on local country operations and that demonstrates efforts to search for local data to support transfer prices — can facilitate a productive dialogue and can increase the likelihood of a positive outcome.

Let's talk

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

Transfer Pricing, Middle East

Dean Kern, *Dubai*
Middle East Tax & Legal Services Leader
+971 (0) 4 304 3575
dean.kern@pwc.com

Mohamed Serokh, *Dubai*
Middle East Transfer Pricing Leader
+971 (0) 4 304 3956
mohamed.serokh@pwc.com

Dan Axelsen, *Dubai*
Transfer Pricing Partner
+971 (0) 2 694 7563
dan.axelsen@pwc.commail

Transfer Pricing Global and US Leaders

Isabel Verlinden, *Brussels*
Global Transfer Pricing Leader
+32 2 710 44 22
isabel.verlinden@be.pwc.com

Horacio Peña, *New York*
US Transfer Pricing Leader
+1 646 471 1957
horacio.pena@us.pwc.com