Egypt updates Transfer Pricing Guidelines

October 2018

In brief

On 23 October 2018, the Egyptian Tax Authority (“ETA”) published an update to the Egyptian Transfer Pricing Guidelines (“ETPG”) which were first issued in 2010.

The update is intended to refresh the 2010 ETPG, in light of the work done by the Organisation for Economic Co-operation and Development (“OECD”) on the Base Erosion and Profit Shifting (“BEPS”) project. The headline changes are the introduction and mandatory filing, of the three-tiered approach to documentation (namely master file, local file and country-by-country report) effective FY 2018 and the introduction of an Advance Pricing Agreement (“APA”) program in the country.

This news alert provides some background to the existing transfer pricing (“TP”) guidance in Egypt, and examines some of the key changes made to the ETPG. It also highlights key points to note for taxpayers subject to Egyptian TP laws in view of the updated guidance.

In detail

Background

In 2005, Egypt became one of the first countries in the Middle East and North Africa (“MENA”) region to introduce specific TP rules in its tax code. Enshrined in Income Tax Law No.91 and its Executive Regulations, these rules define the arm’s length principle, associated enterprises, and the TP methods to be used in determining the arm’s length price.

Article 30 of the law is written to ensure that neither of the parties to the controlled transaction needs be a foreign enterprise – the TP rules apply equally to transactions between associated enterprises resident in Egypt, as well as to those between enterprises resident in Egypt and their non-resident associated enterprises.

The 2010 ETPG, which were generally consistent with the OECD Transfer Pricing Guidelines (“OECD Guidelines”) of the time, were developed to provide Egyptian taxpayers with detailed guidance on how to prepare documentation to support the arm’s length nature of their transactions as required under the law.

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”), formalised the three-tiered approach to TP documentation, and the 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. As an Inclusive Framework member, Egypt has agreed to the implementation of four minimum standards of the BEPS project, including Action 13. The updated ETPG therefore reflect Egypt’s commitment under the Inclusive Framework to implement the recommendations of the BEPS project.

What has changed

The ETPG was originally organised as 5 chapters (addressing the application of Egyptian TP law) and an annex with illustrative examples.

Chapter 1 – The Arm’s Length Principle (“ALP”)
Chapter 2 – Practical application of the ALP
Chapter 3 – Comparability Analysis
Chapter 4 – Pricing methods

Chapter 5 – Documentation and other practical considerations.

In the updated ETPG, these five chapters and the annex are housed within a new Part 1 of the guidance, and contain significant revisions which bridge the gap between the 2010 ETPG and the 2017 OECD Guidelines. Indeed the ETA acknowledges that it has used the OECD Guidelines as a basic reference in preparing the ETPG, and recommends that readers should consult the OECD Guidelines for a “more detailed discussion of the principles”.

Documentation

A large part of the updates relate to the introduction of the three-tiered approach to TP documentation in order to enhance transparency.

The requirements of each of these three tiers are contained in Part 1 Chapter 5 of the ETPG and are broadly in-line with those set out in the OECD Guidelines.

The ETPG confirms that the new documentation requirements will be implemented for fiscal years (i.e. consolidated reporting periods for financial statement purposes) ending 31 December 2018. This is therefore unaffected by taxable years or financial reporting periods of subsidiary entities.

The thresholds for Country-by-Country Reporting (“CbCR”) have been set out in the ETPG

- Egyptian parented groups with a foreign subsidiary / subsidiaries, with an annual consolidated group revenue of equal to or exceeding EGP 3 billion (c. €145 million) will be required to prepare and file a report with the ETA
- Egyptian subsidiaries of foreign-parented groups will be subject to the OECD threshold of €750 million, and required to file a report with the jurisdiction in which the ultimate parent entity is resident.

The ETPG confirms that taxpayers are now required to submit their TP documentation on an annual basis. (Previously, the ETA did not require taxpayers to submit their TP records and documents at the time they filed their tax returns. Instead, documentation was to be submitted to the ETA on their request for tax audit purposes in a timely manner).

<table>
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<th>Documentation filing deadlines</th>
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<td><strong>Master file</strong> – in line with the group ultimate parent’s tax return filing date</td>
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<td><strong>Local file</strong> – within 2 months of filing the tax return</td>
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<td><strong>CbCR</strong> – within 1 year 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</td>
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The master file should be prepared in accordance to the taxpayer group's ultimate parent's tax return filing date, and made available to the ETA “in due course”. By contrast, entity-by-entity local files must be submitted to the ETA “two months following the date of filing the tax return”. The Country-by-Country report (“CbC report”) should in general be submitted “one year following the close of the relevant financial year that it covers”.

Further, the ETPG clarifies that TP documentation should be prepared annually, or existing documentation updated to reflect changes in the business which impact the controlled transactions. Taxpayers should therefore review their TP documentation annually to assess whether it remains valid and accurate. New benchmarking searches are recommended to be done every three years, and the results updated annually by review of the comparables.

TP methods

Since its introduction in 2005, Egyptian TP law prescribed only the three traditional transaction methods for use in determining the arm’s length price of controlled transactions – the Comparable Uncontrolled Price method (CUP), the Cost Plus method (CPM) and the Resale Price method (RPM).

The 2010 ETPG allowed the use of other methods provided in the OECD Guidelines where the main three were unable to be reliably applied. As such the ETPG contained guidance on two further methods – the Profit Split Method (PSM) and the transactional net margin method (TNMM), and a statement on Global Formulary Apportionment.
In May 2018, the Executive Regulations to Income Tax Law No. 91 were amended to include the PSM and TNMM methods as suitable alternatives to the main three, and the updated ETPG now provides revised guidance on the use of these methods in Part 1 Chapter 4, Pricing Methods.

Should taxpayers be unable to reliably apply any of the methods prescribed by the law, other methods can be used. However, the ETA expects taxpayers to first maintain and be prepared to provide sufficient documentation to explain why those methods cannot be reliably applied. In any case, a comparability analysis must be performed to select and apply the most appropriate method.

The updated ETPG also include a statement that the ETA considers “Global Formulary Apportionment as the least reliable method” to be used in determining the arm’s length price of a controlled transaction.

**Risk**

Under the BEPS project, new OECD guidance on the allocation of risks was incorporated into the 2017 OECD Guidelines.

The ETA has been clear to state in the updated ETPG (Part 1 Chapter 3, Comparability Analysis) that it will apply this new OECD guidance when considering the allocation of risks in any particular transaction.

As part of the comparability analysis, taxpayers should ensure that the purported allocation of risks between the associated enterprises in a controlled transaction is consistent with the economic substance of that transaction. The ETA may challenge the purported allocation of risk, where it feels that the entity assuming the risks does not control or have the financial capacity to assume the risk.

**Local comparables**

The ETPG recommends a hierarchical approach to the search for comparables, first considering comparables “in the local market”. If this data is not available, the taxpayer is advised to expand the search to “within the same geographic region”. Similarly if data on the same geographic region is not available, global data on comparables or within those regional markets in which the taxpayer industry’s operating conditions are deemed to be comparable, may be used.

As a result, where the tested party is an Egyptian entity, the initial search should be for Egyptian comparable data, followed by MENA data, and then global data.

**Burden of proof**

One constant in the ETPG is the burden of proof. If the taxpayer complies with the requirements of the law, the burden of proof lies with the ETA to demonstrate non-compliance.

However, a failure to comply with the above changes to the documentation requirements – whether failure to produce documents or the submission of inadequate / incorrect documents – can result in serious consequences for the taxpayer including:

- a high-risk rating and increased risk of audit
- unilateral adjustment of transfer prices by the ETA
- percentage penalties determined according to the amount of the disputed annual tax base, where TP adjustments result from an audit

**Advance Pricing Agreements (APA)**

The ETA has for the first time introduced an APA program to help taxpayers determine, in advance, the appropriate arm’s length price for their controlled transactions with associated enterprises.

This is a welcome measure and one which should deliver benefits such as certainty on TP methodology and tax outcomes, increased transparency, and reduced risks of audit and penalties.

Since the APA program is a new concept in Egypt, the ETA has decided to restrict applications to unilateral APAs only at this point (i.e. agreements that involve one taxpayer and one tax administration only). However, bilateral (BAPA) and multilateral (MAPA) APAs (i.e. agreements involving more than one taxpayer and the relevant tax administrations of two or more governments) will likely be introduced in future.
The guidance on the APA program is contained within a new Part 2 of the ETPG, which describes the mechanisms, procedures and implementation of the program in Egypt.

The option to apply for an APA is open to all taxpayers subject to the provisions of the law, including Permanent Establishments (“PE’s”) (e.g. for transactions between a head office and a PE, or between two separate PE’s of the same enterprise). However the ETA has stated that the program cannot accommodate all taxpayers’ requests and should therefore be used prudently.

The process of applying for and concluding a unilateral APA may take between three to six months, though this may vary depending on the case at hand. The stages of the APA application and administration process broadly include:

- a written request for a pre-filing meeting by the taxpayer at least six months before an APA is proposed to take effect, including an information package containing information prescribed by the ETA
- notification of consensus from the ETA following the meeting, followed by submission of an APA application form and accompanying documentation by the taxpayer
- review of the APA application and documentation package by the ETA
- evaluation and negotiation of APA terms, followed by APA acceptance and signing (or the declining an application)
- annual filing of an APA compliance report by the taxpayer within 60 days of the tax return filing

A news alert containing more detail on the new APA program will be issued separately.

**Points to note**

With the publication of the updated ETPG, the ETA has stated that it “expects taxpayers to be fully prepared to appropriately apply the principles contained herein in practice, and to be fully compliant...” with the Egyptian TP laws.

That being said, there are some points which taxpayers should note, in managing their compliance with the rules.

- The ETPG do not currently incorporate guidance on the ETA’s TP audit process, or the rights and obligations of taxpayers throughout a TP audit process. However, as disclosed in the OECD’s Inclusive Framework Phase 1 Peer Review report, it is expected that such guidance will be introduced in a “Unified Tax Procedures Law” in future. Taxpayers without experience of TP audits in Egypt are advised to seek professional advice to navigate these waters.

- The mechanism for filing of local and master files has not been prescribed by the ETPG. The guidance merely states that these should be submitted directly to the ETA’s transfer pricing department.

- There are currently no materiality thresholds in respect of the local file and master file preparation requirements. As such, the compliance burden for taxpayers with relatively simple business operations will be disproportionate.

- Whilst the ETPG now include guidance on CbCR, the ETA will issue further practical guidance in due course in respect of the CbCR filing requirements (i.e. format, instructions, electronic filing etc). However, it is unclear whether this will also include guidance on the notification requirements and deadlines for notification (if any) for filings outside of Egypt etc, as well as the ETA’s position and procedures for surrogate filings in Egypt.

- There is some clarification required on the calculation of the CbCR threshold, for example the appropriate reference year to be used for the calculation, and how the calculation will be monitored by the ETA.

- The CbCR group consolidated revenue threshold is significantly lower for Egypt-parented groups (c. €145m) than for Egyptian subsidiaries of foreign-parented groups (€750m), thus placing an unique compliance requirement on the former.
Future work

The ETA has stated its intention to publish separate in-depth practical guidance on the application of the arm’s length principle to transactions involving intangible property, controlled services, and cost contribution arrangements (CCAs), as well as the tax treatment of PE’s and the attribution of profits to a PE, and other industry specific guidance. These should provide greater clarity to taxpayers with more complex activities in Egypt.

As mentioned earlier, the ETA also intends to issue further practical guidance in due course, in respect of the CbCR filing requirements (i.e. format, instructions, electronic filing etc).

The takeaway

The steps taken by the ETA to provide updated guidance demonstrate its commitment to implementing the minimum standards under the BEPS Inclusive Framework and enhancing transparency. The updated ETPG are also welcome in providing greater clarity to taxpayers in some areas, for example on the application of the arm’s length principle, the choice of TP methods and the general compliance requirements. Finally the newly introduced APA regime is good news for taxpayers looking to gain certainty over their TP methods and tax outcomes.

However, there are some pertinent aspects for taxpayers to consider including:

- annual preparation, and mandatory filing, of three tiers of documentation
- incorporating the search for appropriate local or regional comparables in line with the guidance
- the unique compliance requirement for smaller Egypt-parented groups resulting from a significantly lower CbCR threshold (c. €145m compared to the OECD threshold of €750m)
- consequences of non-compliance with the rules, including the risk of audit and therefore adjustments and penalties
- application of the TP rules to include transactions between associated enterprises resident in Egypt
- experience of TP audits in Egypt, whilst awaiting further guidance in the Unified Tax Procedures Law
- managing the APA process whilst practical experience with the guidance develops

There are also significant questions on the practical application of the rules in other areas, though these may be addressed as future guidance is released by the ETA.

One thing is clear – taxpayers should plan and execute carefully especially with the onus being firmly on them to be compliant, and to be able to demonstrate compliance, with the laws. They should view these updates as a signal of change, as well as an opportunity to review their transfer pricing practices accordingly.
Let’s talk

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

**PwC contacts**

Mohammed Yaghmour  
*Zakat and Tax Leader, KSA*  
T: +966 12 610 4400  
E: mohammed.yaghmour@pwc.com

Abdallah El Adly  
*Tax Services Leader, Egypt*  
T: +202 27597887  
E: abdallah.eladly@pwc.com

Karim Emam  
*Tax Partner, Egypt*  
T: +202 759 7881  
E: karim.emam@pwc.com

Abdelkhalek Ahmed  
*Financial Accounting and Administrative Services Leader, Egypt*  
T: +202 2759 7889  
E: abdelkhalek.ahmed@pwc.com

Safwat Sobhy  
*Tax Partner, Egypt*  
T: +20 100 175 2347  
E: safwat.sobhy@pwc.com

Ahmed Osama  
*Tax Partner, Egypt*  
T: +202 759 7864  
E: ahmed.osama@pwc.com

Mohamed Serokh  
*Middle East Transfer Pricing Leader*  
T: +971 4304 3956  
E: mohamed.serokh@pwc.com

Lav Chadha  
*Transfer Pricing Partner*  
T: +971 56 682 0663  
E: chadha.lav@pwc.com

Maged Ezzeldeen  
*Country Senior Partner,*  
T: +20 (0) 2 27597877  
E: maged.ezzeldeen@pwc.com

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