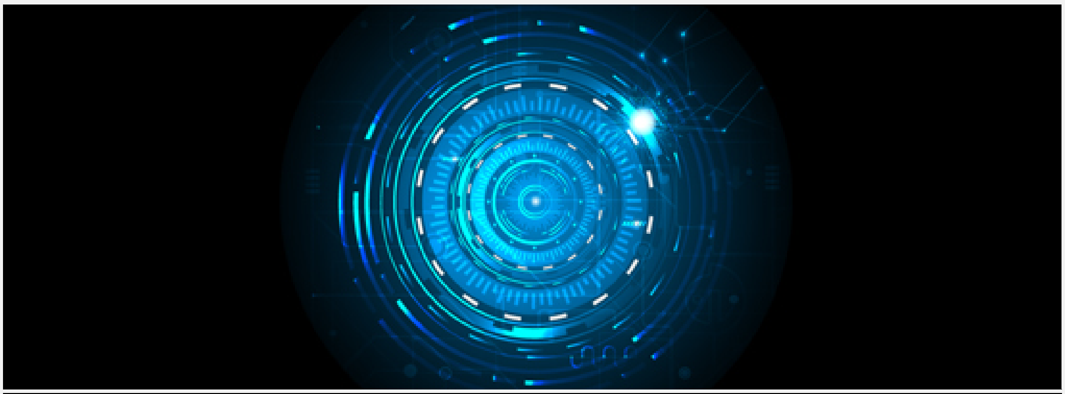

Egypt releases updated transfer pricing guidelines

Global Transfer Pricing Alert 2018-032

The Egyptian Tax Authority (ETA) on October 23 released an updated version of its transfer pricing guidelines, which were first issued in 2010.

The update is intended to refresh the 2010 Egyptian guidelines in light of the work conducted by the Organisation for Economic Co-operation and Development (OECD) on the base erosion and profit shifting (BEPS) project, and to provide an important source of guidance for how the ETA is likely to interpret Egyptian transfer pricing rules.

This alert provides some background to the existing transfer pricing guidance in Egypt, and examines the key changes made to the transfer pricing guidelines.

The key changes for multinational enterprises (MNEs) operating in Egypt under the updated guidelines can be classified into two categories:

- The introduction of the three-tiered approach to transfer pricing documentation (master file, local file, and country-by-country report) for the first time in Egypt effective FY 2018; and
- The launching of the APA program in Egypt.

To incorporate those changes, ETA splits its published transfer pricing guidelines into two parts. Part I includes five chapters that cover:

- The arm's length principle
- Application of the arm's length principle
- Comparability analysis

- Pricing methods
- Documentation

Part II in its entirety is dedicated to the newly introduced APA program in Egypt. A detailed review of the changes follows below.

Transfer pricing method selection

In May 2018, the Executive Regulations to Income Tax Law No. 91 were amended to include the profit split method and the transactional net margin method (TNMM) as suitable alternatives to the main three methods (the comparable uncontrolled price method, the resale price method, and the cost plus method) and the updated transfer pricing guidelines now provide updated guidance on the use of these methods in Part 1, Chapter 4, Pricing Methods.

Previously, the 2010 transfer pricing guidelines allowed the use of transactional profit methods provided in the OECD transfer pricing guidelines when taxpayers could not reliably apply the main traditional transaction methods. Now, the updated version of the guidelines aligns with the OECD transfer pricing practice, placing all methods on an equal footing by abolishing the hierarchy of methods.

If taxpayers are 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. Also, the updated guidelines contain guidance on two additional methods – the profit split method and the TNMM -- and a statement on global formulary apportionment.

Risk Allocation

Chapter 3 of the updated guidelines applies new guidance on a six-step process for identifying and analyzing risk in a controlled transaction, adopted from the 2017 version of the OECD transfer pricing guidelines, which incorporate the changes made under the BEPS project.

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

Comparability analysis: localization approach

The updated guidelines recommend a hierarchical approach to the search for comparables. That is, when applying any comparables-based method, taxpayers should first limit their comparability searches to the Egyptian market. Then, if Egyptian comparables cannot be identified, taxpayers may gradually expand the geographic scope of the search to include regional comparables (within the Middle East and Africa). Finally, if Middle Eastern and African comparables cannot be located, global comparables may then be searched for.

Three-tiered approach to documentation

Starting next year, MNEs in Egypt will be required to submit (1) a local file, (2) a master file, and (3) a country-by-country report.

Taxpayers should submit both local and master files directly to the ETA's transfer pricing department. Because the master file relates to the GAE (Group of Associated Enterprises) as a whole, it should be prepared in accordance with the GAE's ultimate parent's tax return filing date; hence, it should be made available to the ETA by the taxpayer in due course. The local file should be prepared on an entity-by-entity basis, not on a group basis (that is, for two or more related taxpayers resident in Egypt for tax purposes), and is required to be submitted to the ETA's transfer pricing department two months following the due date for filing the tax return. This is a major departure from ETA's former approach of requiring documentation from taxpayers only upon request.

The thresholds for requiring a country-by-country report (CbCR) have been set out in the updated guidelines:

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

The first CbCR should be prepared for the subject GAE's fiscal year ending December 31, 2018, and should be filed within 12 months after the closing of the GAE's 2018 fiscal year. As such, only Egyptian-parented GAEs will be required to file a CbCR with ETA.

Frequency of documentation

The ETA confirms in the updated guidelines that taxpayers should prepare their transfer pricing documentation annually to support their transfer pricing position, or update their existing transfer pricing documentation to reflect any changes in the business that will substantially impact their controlled transactions. However, in an attempt to reduce compliance burdens, the ETA relieved companies from preparing annual benchmarking by recommending that a new search should be carried out every three years. Nonetheless, the benchmarking analysis should still be updated annually, together with the company's financial information and transaction(s) in order to make sure that the arm's length principle is reliably applied.

Retaining documents and records

Taxpayers are obligated to keep records and documents for five years starting from the legal deadline for filing the transfer pricing documentation for the tax period. In some cases, it is in the taxpayer's best interest to retain transfer pricing documents beyond that period, particularly when such documents support the reliability of transfer prices established for a subsequent year, as in the case of long-term contracts.

Burden of proof

If a taxpayer fails to submit documentation within the allotted time, or submits inadequate or incorrect documentation, the taxpayer runs the risk of:

- Being designated as a high tax risk by the ETA, which would subject the taxpayer to increased risk of audit;
- Unilateral adjustment of transfer prices by the ETA; or
- Being subject to penalties determined according to the amount of the disputed annual tax base, when transfer pricing adjustments result from an audit.

APA program

The ETA has for the first time introduced an APA program in Egypt. At this time, the program is limited to accepting applications for unilateral APAs, to help taxpayers determine, in advance, the appropriate arm's length price for their controlled transactions with associated parties.

Concluding an APA with the ETA is subject to the ETA's approval of the APA request submitted by the taxpayer. The process to obtain an APA is as follows:

- The taxpayer must make a written request to the transfer pricing department within ETA for a prefiling meeting, at least six months prior to the first day of the proposed covered period.
- The ETA will provide a notification of consensus, followed by the taxpayer's submission of the APA application.
- The ETA will review the APA application and documentation package.
- The ETA will evaluate and negotiate the APA terms, followed by the taxpayer's acceptance and signing of the APA.
- The taxpayer must file an annual APA compliance report within 60 days of the tax return filing due date.

The entire process is estimated to take between three to six months.

Future work

In the updated guidelines, the ETA has committed itself to publish another set of guidelines that would address issues regarding the application of the arm's length principle to intangible property transactions, cost contribution arrangements, controlled services transactions, and attribution of profits to a permanent establishment as its subjects of scrutiny.

Comments

The updated transfer pricing guidelines provide greater clarity to taxpayers on the application of the arm's length principle, the choice of transfer pricing methods, and general compliance requirements. However, additional guidance is needed in some areas. For instance, the guidelines do not provide a mechanism for filing the local and master files; the guidance merely states that these files should be submitted directly to the ETA's transfer pricing department. Also, there are currently no materiality thresholds in respect of the local file and master file preparation requirements, which increases the compliance burden for even small-scale business operations.

Finally, the newly introduced APA regime is good news for taxpayers looking to gain certainty over the treatment of their transfer pricing methods and tax outcomes.

The ETA should provide clarity and guidance on an audit framework and dispute resolution, from planning, execution, and through to the resolution phases. Such guidance will be necessary to help MNEs and the tax administrations converge on a globally accepted set of practices that are compliant with the arm's length principle.

For taxpayers, the updated transfer pricing guidelines provide a good opportunity to review their existing transfer pricing practices to comply with the requirements of the law, to avoid a high-risk rating and increased risk of audit.

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