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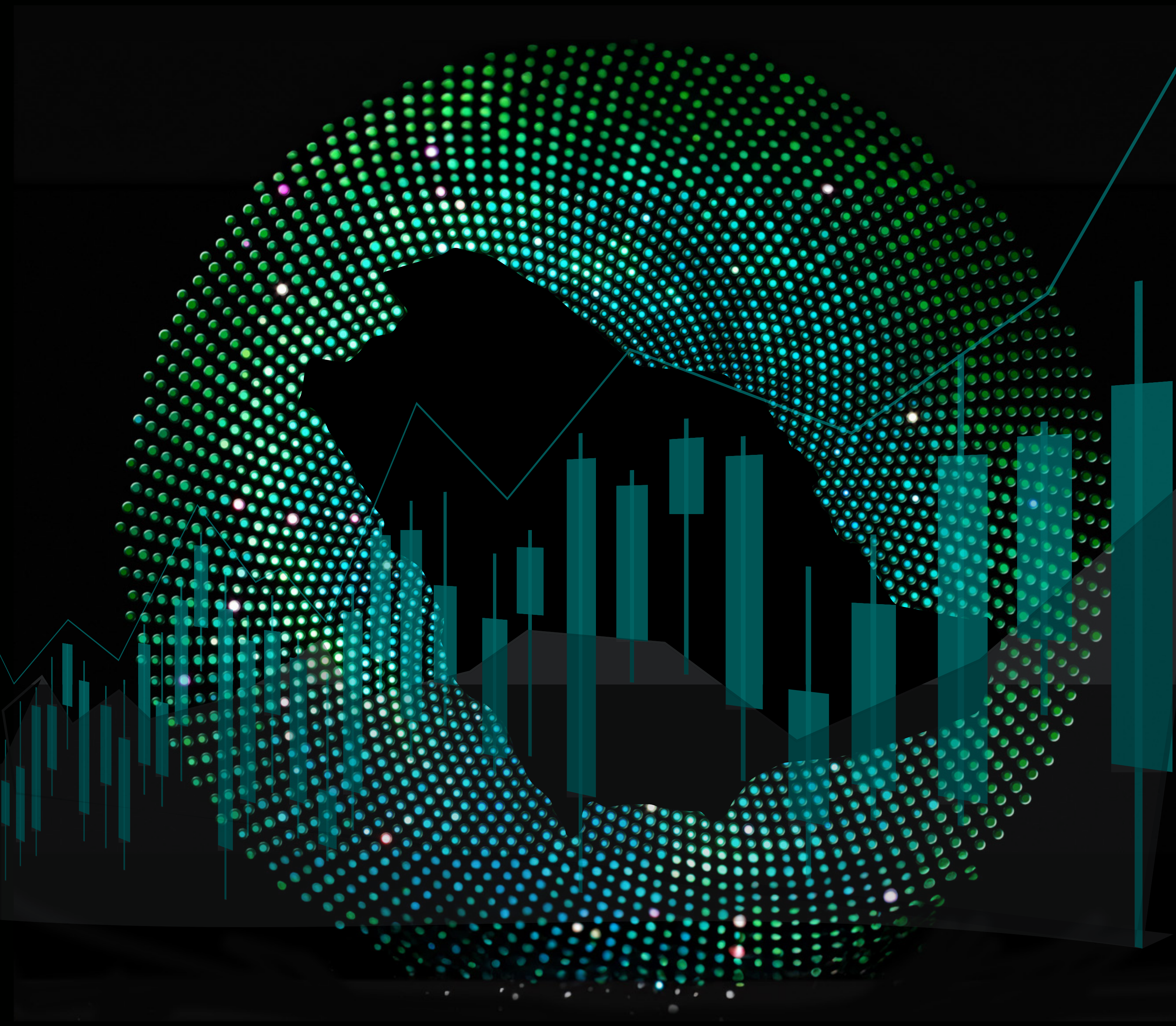


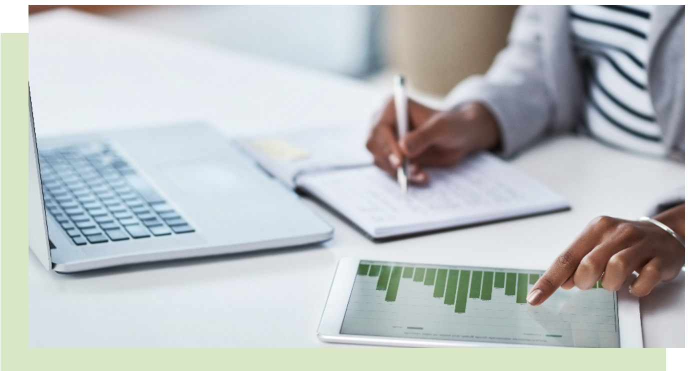
Navigating Transfer Pricing for Regional Headquarters in KSA: An In-Depth Analysis

March 2024

Introduction

In the vibrant business landscape of the Kingdom of Saudi Arabia (KSA), significant changes in the corporate tax and regulatory environment are evident. Starting from 1 January 2024, the Regional Headquarter (RHQ) program, following several years of discussions, has come into effect. Multinational enterprises (MNEs) are expected to establish RHQs in KSA to continue doing business with the KSA government, thereby enhancing operational efficiency and market penetration. This strategic move, however, introduces a host of transfer pricing (TP) considerations. This article aims to unravel some of these complexities, providing a comprehensive guide to transfer pricing for RHQs in KSA.

Transfer Pricing for RHQs



At its core, transfer pricing revolves around the arm's length principle, ensuring that transactions between related entities mirror those occurring between independent parties, establishing an arm's length value for tax purposes. This principle is not merely a regulatory requirement but a fundamental aspect of global and local business ethics and efficiency. For RHQs in KSA, adherence to this principle is paramount to avoid potential penalties (if any), double taxation, and to safeguard their reputation, thus ensuring smooth operations in compliance with local laws.

Delving into Key Transfer Pricing Considerations

The journey of establishing and managing an RHQ in KSA brings several crucial transfer pricing considerations to the forefront:

1. Business Restructuring: The creation of an RHQ could involve significant organizational changes, including the relocation of key personnel from other parts of the group to the RHQ in KSA. This process, classified as 'Business Restructuring,' carries notable transfer pricing implications and necessitates an assessment to ensure compliance with the arm's length principle. Establishing a business restructuring could be quite significant since it may entail an “exit charge” in some instances, in accordance with the transfer pricing principles.

2. Cost Allocation: Situations may arise where the RHQ established in KSA shares resources with its other affiliates in KSA, requiring the allocation of costs between the affiliates and the RHQ. Developing a transparent and equitable method for sharing expenses related to office space, utilities, and services is essential from a transfer pricing perspective.

3. Sub-Contracting by RHQ to Other Group Entities: In certain cases, the RHQ may sub-contract certain services to third parties or other group entities. A careful analysis is required to determine whether these costs should be considered as pass-through in nature for the RHQ, especially if the RHQ is remunerated on a cost-plus basis. Additionally, the characterization of third-party or related-party costs as pass-through costs would also need to be analysed from a withholding tax perspective to see whether these costs would benefit from the 0% withholding tax rates (if these third parties or group entities are not based in KSA).

4. Remuneration Mechanism: Determining an appropriate remuneration methodology for RHQs is a complex task that extends beyond the simplistic cost-plus mark-up approach. It requires a customized and nuanced approach that reflects the strategic importance and the actual value derived from the RHQ's services. We have delved into this in detail in the next part of this article.

5. Allocation of Service Fees: Given that RHQs would often provide services to multiple entities within the MNE group, establishing a fair and transparent method for allocation of service charge between the entities is crucial, especially when adopting a simplified cost-plus approach. This process involves careful consideration of various metrics to ensure compliance with transfer pricing principles.

6. Segmentation in Case of Non-Eligible Activities: The recently published tax rules[1] applicable to RHQs also specify that profits from non-eligible activities would be subject to taxes in

[1]The Tax Rules for RHQs were published by the Zakat, Tax, and Customs Authority (ZATCA) on 16 February 2024.

accordance with the provisions of the tax law. In the event that an RHQ is engaged in such non-eligible activities, appropriate segmentation, including allocation of costs between eligible and non-eligible activities, would need to be done to ensure that the profits from eligible activities can benefit from the tax incentives.

7. Tax and Regulatory Considerations: Entities receiving services from the RHQ must demonstrate that charges for such services comply with the arm's length principle, ensuring that these costs are justifiably deductible (i.e., meet the benefits test requirement) and also meet regulatory standards.

8. Inter-Company Agreements: These agreements are vital, detailing the RHQ's responsibilities, expectations, and the basis for remuneration, aligning with transfer pricing regulations and business objectives.

9. Transfer Pricing Documentation: The tax rules for RHQ also specify that RHQs would be subject to comply with the KSA Transfer Pricing Bylaws. This entails complying with various transfer pricing requirements, including the TP disclosure form, TP Affidavit, and 3-tier TP documentation, which are applicable to any other tax or zakat payer. In addition, since the RHQs would also be required to comply with Economic Substance Requirements (ESR), they need to ensure alignment between the transfer pricing documentation and the annual ESR report.

Consistency of the Remuneration Mechanism with Transfer Pricing Principles

The remuneration mechanism for RHQs requires alignment with the KSA Transfer Pricing Bylaws which are largely aligned with the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines, which emphasize that the remuneration methodology should reflect the economic value of inter-company transactions in the case of intra-group services. This alignment ensures that the remuneration mechanism for RHQs accurately represents the functions performed, assets utilized, and risks assumed.

Functional Analysis: The Foundation of Transfer Pricing

A detailed functional analysis stands at the heart of determining the appropriate remuneration for RHQs. This analysis assesses the functions performed, assets employed, and risks undertaken by the RHQ, and also differentiates between shareholder activities and value-adding activities:

- **Shareholder Activities:** These activities benefit the corporate group as a whole, such as governance and compliance functions. The TP Guidelines typically do not require these activities to be remunerated by other entities within the group, considering them as intrinsic to the shareholder's interests. In the case of RHQ, the costs related to such shareholder activities may need to be passed on to the ultimate parent entity of the MNE group.

- **Value-Adding Activities:** Activities that directly contribute to the operational efficiency and competitive advantage of the MNE group warrant appropriate remuneration. The value of these activities, discerned through a comprehensive functional analysis, dictates the remuneration mechanism.

Selecting the Appropriate Remuneration Method for Value-Adding Activities

The selection of a remuneration method depends on the outcome of the functional analysis:

- **Cost-Plus Method:** Often applied to routine or low value-added services, this method calculates remuneration based on the costs incurred by the RHQ plus a markup reflecting a market-based profit. It suits services with measurable inputs and outputs.

- **Alternative Methods:** For services that are strategic or non-routine, alternative remuneration methods might be more fitting. These can include remuneration based on the outcomes achieved, the value of goods sourced, or a percentage of revenues or profits (including application of profit split methods), thereby capturing the economic reality and the RHQ's contribution to the MNE group.

Benchmarking studies play a crucial role in justifying the chosen remuneration method, ensuring it aligns with the arm's length principle by comparing it to similar market or third-party comparable transactions.

Documentation and Compliance: Solidifying the Approach

Having robust transfer pricing documentation is indispensable for substantiating the chosen remuneration method's compliance with the arm's length principle. Detailed records of the functional analysis, the rationale behind the selected remuneration method, and the outcomes of benchmarking studies are essential. This documentation not only supports compliance with OECD TP guidelines and local KSA TP regulations but also equips the RHQ to defend its transfer pricing strategy effectively. It would also be required to protect the RHQs from any penalties prescribed under the tax rules for RHQs, including revocation of the RHQ tax incentives for non-compliance with the transfer pricing requirements.

Conclusion

Mastering transfer pricing for RHQs in KSA is an intricate endeavor, requiring a deep understanding of both regulatory landscapes and the strategic value of the RHQ's services. By meticulously considering the aspects outlined, including a comprehensive approach to remuneration aligned with international standards, MNEs can ensure their RHQs are not just compliant but are also strategically positioned to contribute significantly to the global enterprise's success.

Contacts

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