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Changing Transfer Pricing Landscape in the Kingdom of Saudi Arabia

Preparing for Advance Pricing Agreements

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Introduction

On 20 March 2023, the Board of Directors of Saudi Arabia's Zakat, Tax and Customs Authority ("ZATCA") approved amendments to the Transfer Pricing Bylaws ("TP Bylaws"), which included the introduction of an Advance Pricing Agreement ("APA") program under Article 23 of the revised TP Bylaws.

According to the revised TP Bylaws, Taxpayers and Zakat payers would be eligible to obtain an APA provided that:

1. The value of transactions covered under the APA application is not less than SAR 100 million (~USD 26.66 million); and
2. The APA application is submitted at least twelve (12) months before the beginning of the first financial year covered under the APA.

In relation to the first condition, the TP Bylaws also provide that ZATCA may allow certain complex / sophisticated transactions to be covered under the APA even if the value does not exceed the prescribed threshold of SAR 100 million.

Additionally, the TP Bylaws also provide for the following:

1. ZATCA will hold a pre-filing meeting to evaluate the APA application before accepting the request to proceed with the APA application;
2. APA will cover a period of three (3) years, subject to the Taxpayer/Zakat payer submitting annual compliance reports;
3. ZATCA may apply the principles of APA to years preceding the Taxpayer's application (i.e., rollback of APA to prior years).

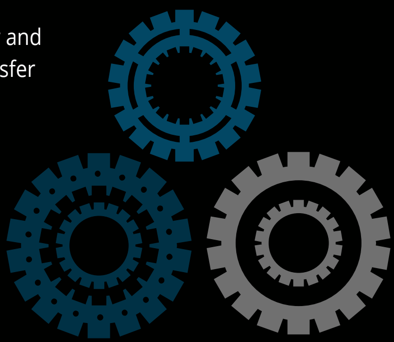
We expect additional guidance will be published by ZATCA in due course in relation to the APA program.

This article provides a general overview of APAs to help provide context for the upcoming changes in the transfer pricing landscape in the Kingdom of Saudi Arabia.

What is an APA?

An APA is a binding agreement between a Taxpayer and a tax authority that establishes an appropriate transfer pricing methodology for related-party transactions.

APAs provide Taxpayers with certainty regarding the tax treatment of their related party transactions, helping to reduce compliance costs and mitigate transfer pricing disputes.



APAs are generally negotiated between the Taxpayer and the tax authority before the relevant transactions occur and are typically valid for a specified period of time ranging from 3 years to 5 years. In certain cases, APAs can also provide for a roll-back option which allows the Taxpayers to also cover a specified number of years (ranging from 3 years to 5 years) prior to the submission of the APA application.

What are the types of APAs?

- **Unilateral APAs –** These are agreements between a Taxpayer and the tax authority in the country where the Taxpayer operates. They are generally used where the Taxpayer cannot access the bilateral/multilateral APA option due to the non-existence of a Tax Treaty. Unilateral APAs provide certainty from the perspective of the Taxpayer, where the Taxpayer operates; In the case of cross-border transactions, Unilateral APAs could result in double taxation if the tax authorities in the counter-party tax jurisdiction do not agree with the outcome of the unilateral APA.

- **Bilateral APAs –** These are agreements between a Taxpayer, the tax authority in the country where the Taxpayer operates, and the tax authority in the country where the related party operates. Bilateral APAs are preferred over Unilateral APAs as they would help in eliminating double taxation. The disadvantage of bilateral APA over a unilateral APA is generally the time period it takes to reach a conclusion.

- **Multilateral APAs –** These would involve multiple (more than two) tax authorities and Taxpayers from their respective tax jurisdictions.

In the context of KSA, we expect that the ZATCA would accept unilateral, bilateral, and even multilateral APAs. We expect clarity on this once additional guidance is published by ZATCA.

What are the advantages of an APA for a Taxpayer?

- **Reduced compliance costs:** APAs can help reduce the time and resources spent by the Taxpayer on complying with transfer pricing regulations.

- **Increased certainty in tax planning:** APAs provide Taxpayers with certainty about the tax treatment of their related party transactions, which help them plan their business operations more effectively. APAs also provide the Taxpayer with an option to discuss complex matters with tax authorities which might otherwise not be feasible due to time limits imposed on a post-facto transfer pricing audit/litigation process.

- **Reduced risk of transfer pricing audits and disputes:** By establishing an agreed-upon transfer pricing methodology, APAs reduce the risk of transfer pricing audits and disputes (unless the critical assumptions which are agreed as part of the APA do not hold true) and could also be helpful in eliminating double taxation.

- **Avoidance of litigation and potential penalties for noncompliance with transfer pricing rules:** APAs can provide Taxpayers with a framework for resolving differing opinions between the Taxpayer and tax authority without the need for litigation, which is generally very costly and time-consuming.

What are the advantages of an APA for Tax Authority?

- **Provides a means of resolving transfer pricing matters in a cooperative and efficient manner:** By negotiating an APA, tax authorities can work with Taxpayers to resolve transfer pricing matters in a cooperative and efficient manner, without being constrained by specific time limits which generally apply in a post facto transfer pricing audit situation.

- **Helps tax authorities allocate resources more effectively:** By reducing the number of transfer pricing disputes, tax authorities can allocate their resources more effectively and focus the efforts on field audits for Taxpayers who have not applied for an APA.

- **Reduces the number of transfer pricing disputes:** By establishing an agreed-upon transfer pricing methodology, APAs generally help reduce the number of transfer pricing disputes and helps in freeing up time which is generally spent by appeal committees/courts on transfer pricing cases.

- **Improves the overall relationship with Taxpayers:** By working collaboratively with Taxpayers to negotiate an APA, tax authorities can improve their relationship with Taxpayers and foster a more conducive business environment.

What are the typical stages involved in obtaining an APA?

Stage 1 - Pre-filing consultation:

Taxpayers can meet with the tax authority to discuss the possibility of negotiating an APA, including understanding the expectations of the tax authorities in terms of information which would be required during the APA process. It also provides an opportunity for the tax authority to determine whether they would be willing to process the APA application if filed by the Taxpayer. Pre-filing consultations are generally non-binding in nature, and if permitted by the regulations, can also be conducted on an anonymous basis without disclosing the name of the Taxpayer.

In the context of KSA, a pre-filing meeting is a mandatory step before the ZATCA proceeds with the acceptance of the APA application. However, it needs to be seen whether the pre-filing meeting would be permitted on an anonymous basis and whether there will be a separate application for the pre-filing meeting before a formal APA application is lodged with ZATCA.

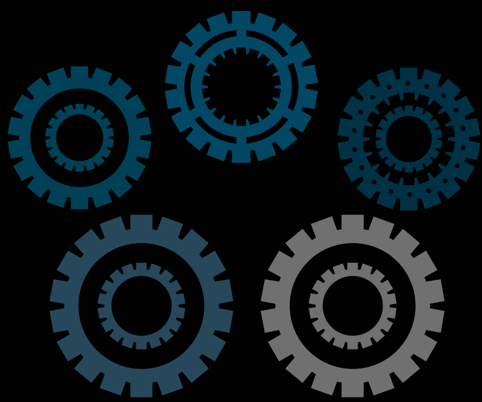
Stage 2 - Formal APA request:

Taxpayers must submit a formal request to negotiate an APA outlining their position on the transfer pricing methodology in relation to their related-party transactions. An APA application would typically include the following:

Overview of the Group and the Taxpayer;

Market conditions and economic environment in which the Taxpayer operates;

Functional analysis in relation to the transaction which the Taxpayer intends to cover under an APA ('covered transactions');



Economic analysis in relation to the covered transaction, including the pricing policy in relation to the covered transactions; and

Critical assumptions in relation to the covered transactions for the APA period.

In the case of a Unilateral APA, the Taxpayer would submit the APA application with the tax authority of the country where it operates. In the case of a bilateral/multilateral APA, the Taxpayers/related parties would submit the APA application (which ideally should be the same document) in the respective tax jurisdictions where they operate.

In the context of KSA, Taxpayers and Zakat payers would need to wait for ZATCA to publish additional guidance, which we expect would provide clarity on the format/contents of the APA application, the filing process whether this is to be submitted manually or through an online portal, whether there will be any filing fees, etc.

Stage 3 - Review and analysis:

Once the APA application has been submitted, the tax authority will review the Taxpayer's request and perform an analysis of the relevant facts and circumstances. This could also entail meeting the Taxpayers to gather more facts/understanding about the business/covered transactions. In addition, in certain cases, tax authorities may also conduct site visits including meeting key functional heads to validate the functional analysis which the Taxpayer provides as part of the APA application.

In the context of KSA, it needs to be seen whether the tax authorities would also be conducting site visits and would carry out independent functional interview meetings to validate the facts stated in the APA application submitted by the Taxpayer/Zakat payer.

Stage 4 – Position paper:

Once the APA authorities have conducted their fact-finding, they will prepare their own position paper which would summarize their view on the transfer pricing approach suggested by the Taxpayer.

In the case of a unilateral APA, the position paper is generally shared with the Taxpayer. Whereas, in the case of a bilateral/multilateral APA, the position paper will be exchanged between the competent tax authorities of the tax jurisdictions which are party to the APA process.

In the context of KSA, we expect more clarity once the additional guidance is published by ZATCA.

Stage 5 – Negotiation:

This is the stage where the final terms of the APA will be negotiated between the tax authority and the Taxpayer.

In the case of a unilateral APA, after the position paper has been shared, the Taxpayer and tax authority will negotiate and come to a conclusion on the final terms of an APA.

In the case of a bilateral/multilateral APA, the competent authorities of the respective tax jurisdictions will negotiate the final terms of the APA, and the outcome will be communicated by the tax authority in the respective country with the Taxpayer for acceptance or otherwise.

Stage 6 – Signing:

Once the terms of the APA have been agreed upon, the Taxpayer and tax authority will sign the agreement, which will be binding for the years covered under the APA in relation to the covered transactions (subject to meeting all the critical assumptions throughout the APA period).

In the context of KSA, we expect more clarity once the additional guidance is published by ZATCA. However, we do expect that unlike Advance Rulings, since an APA would involve an agreement that would be signed between the Taxpayer/Zakat payer and ZATCA, an APA application would be binding in nature.

Stage 7 – Post APA compliance:

During the APA term, the Taxpayer would be required to comply with the terms of the APA, which may include providing the tax authority with annual compliance reports on related-party transactions, including demonstrating that there have been no changes in the critical assumptions agreed as part of the APA. The tax authorities may also undertake APA compliance audits to assess the accuracy and completeness of the annual compliance report.

In the context of KSA, the TP Bylaws do provide that Taxpayers/Zakat payers would be required to submit annual compliance reports. However, we expect clarity once additional guidance is published by ZATCA on the format/contents of the annual compliance reports, and whether the tax authorities would be conducting compliance audits and the frequency/timeline for completing such audits.

How many years are typically covered in an APA?

The number of years covered by an APA can vary depending on the jurisdiction and the specific circumstances of the Taxpayer. Typically, APAs cover a period of three to five years, although some tax jurisdictions allow for longer periods. Also, if there are no changes in the critical assumptions, the Taxpayer may be able to renew the APA after its expiry with limited efforts.

The duration of the APA should strike a balance between providing the Taxpayer with a degree of certainty and stability and allowing for adjustments if market conditions change or if the Taxpayer's business undergoes significant changes.

Taxpayers would need to consider the potential costs and benefits of the APA duration, as longer durations may require more time and resources to negotiate and implement, while shorter durations may provide less certainty and require more frequent negotiations.

In the context of KSA, the TP Bylaws provide that the APA application would cover three (3) years. However, we expect that the APA renewal process should be fairly straightforward and less time-consuming if there are no changes in the fact pattern of the Taxpayer/Zakat payer.

Looking forward

The introduction of the APA program is a positive and significant development. It provides Taxpayers and Zakat payers with an alternative and binding arrangement with ZATCA, and it will also provide upfront certainty on transfer pricing positions for a defined period.

We expect that the publication of the revised TP Bylaws and the introduction of the APA program, followed by guidance notes or frequently asked questions ('FAQs'), will clarify a number of areas discussed above. These include questions such as:

1. Will there be any filing fees to be paid by Taxpayers?
2. Will Taxpayers be able to cover domestic transactions as part of the APA, or will it be restricted to only cross-border transactions?
3. What will be the process for filing an APA application?
4. Will ZATCA conduct site visits as part of the APA process?
5. Will the Taxpayer be allowed to withdraw from the APA process?
6. Will the APA program allow roll-back to cover prior years?
7. Will ZATCA specify any time limit by when the APA will need to be concluded?
8. What will be the obligations upon the Taxpayer post the conclusion of the APA?
9. What will be the composition of the APA team within ZATCA?

It is important to note that the current transfer pricing guidelines do specify that Taxpayers may approach ZATCA for a non-binding ruling if they require more information about the application of the TP Bylaws to their situation. However, in our experience, we have not seen taxpayers considering this option due to the non-binding nature of such advance rulings. With the introduction of APAs, which we expect would be binding agreements, it is expected that Taxpayers and Zakat payers will consider APAs more positively as they offer upfront certainty.

To conclude, considering ZATCA's history of challenging Taxpayers on their transfer pricing positions, it is advisable for Taxpayers and Zakat payers to evaluate whether they need an APA, taking into account the complexity and nature of their related-party transactions. If an APA is being considered, it is crucial to start preparing in advance to ensure that such transactions can be covered as soon as the APA program commences.

Contacts

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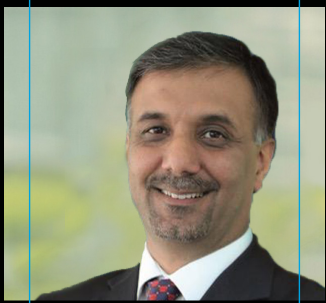

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