

The post pandemic Transfer Pricing environment in the Middle East: Important decisions

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Introduction

Earlier this year, the International Monetary Fund (IMF) revised its growth forecast upward for the Middle East (ME) and North Africa (MENA) region. As countries recover from the Covid-19 crisis that began in 2020, real Gross Domestic Products (GDP) in the MENA region are expected to growth projection by 4% in 2021, the IMF's October projection is 3.2%. It is evident that economies are opening up and businesses are rebounding, seeking to continue their operations in the 'new normal' environment.

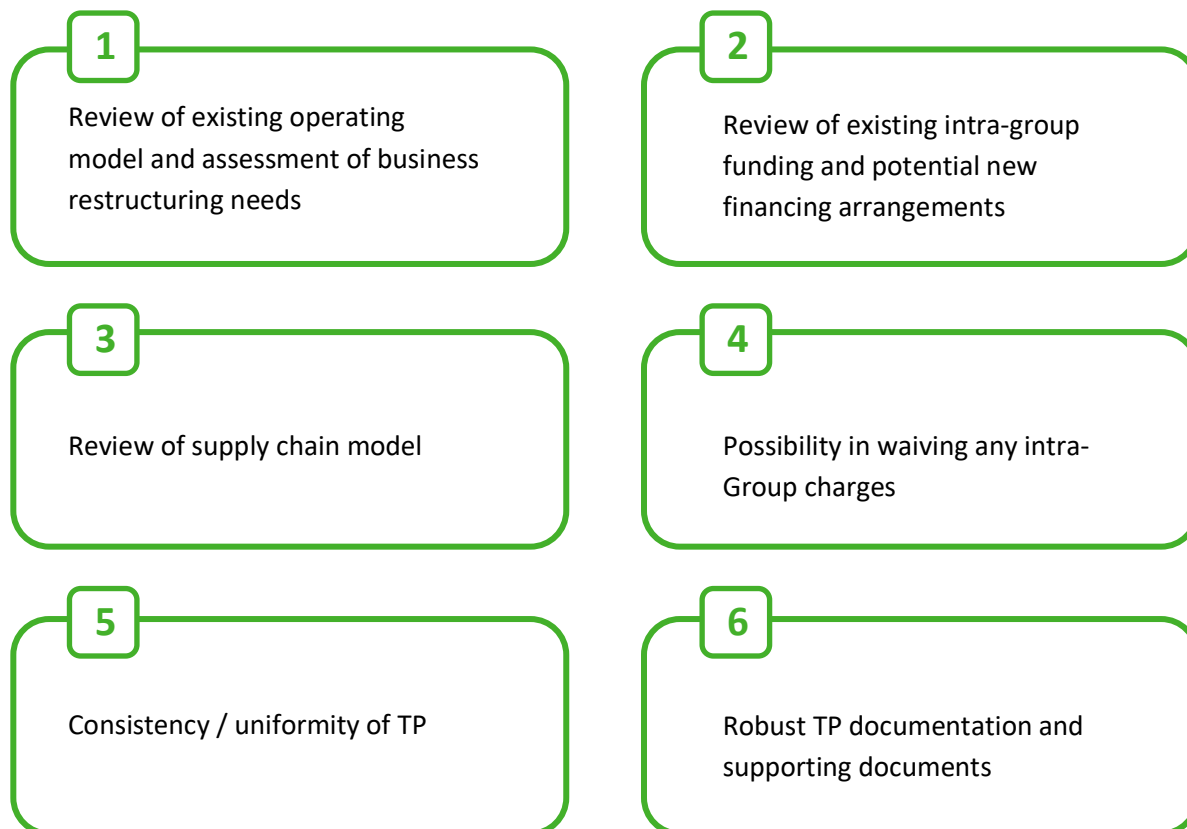
Even as economies across the ME rebound, governments are seeking additional tax revenues to promote and escalate economic recovery. Transfer Pricing (TP) is a significant factor in determining the income allocated to each jurisdiction and thereby the corporate income taxes paid by Multinational Enterprises (MNEs) in these jurisdictions. Whilst, TP is relatively new in the region, the denial of deductions or value reduction on certain related party transactions (for example management fees and royalties) for tax purposes are routinely seen as easy targets for tax authorities. This has been evidenced by the significant increase in volume in TP audits in a number of countries across the region.

In light of the above trends, it is important for MNEs operating in the ME to revisit and monitor their TP arrangements, in order to defend their position whenever the local tax authorities raise any queries. Many MNEs were in a loss-making position last year and are likely to still be in a loss-making position this year given the impact of the pandemic, which increases the likelihood of tax authorities' interest in their arrangements.

So, what are the areas that MNEs should decide on during these uncertain times? Should certain TP and tax related topics be higher up on the agenda? If so, what should businesses operating in the ME be doing to proactively manage tax risk in the new post pandemic environment? Let's find out.

Key TP priorities

Given the economic impact of the pandemic that MNEs are facing and the approaches that regional tax authorities are taking on recent audits, below is a summary of some of the most important issues MNE's are facing in the post pandemic environment in the Middle East.



Below, we summarize a brief discussion on each of these issues.

(1) Review of existing operating model and assessment of business restructuring needs

Many businesses have faced the negative impacts of the economic downturn driven by the pandemic. MNEs have recorded low operating profits or losses in certain jurisdictions where they operate, or even on a Group wide basis. MNE's operating in the ME have found it increasingly important to prove that the losses incurred were due to commercial and wider pandemic related issues and not due to mis-priced intra-group transactions. Given recent TP audit developments and tax authority approaches toward losses, operating result justification is more important than ever.

Many MNEs in the ME region did not undertake a holistic review of their operating models prior to the pandemic. On that basis, a review by the MNE's on the following factors is of critical importance:

- Whether the MNE's current operating model, (e.g. a centralized or decentralized TP model) is still suitable for the MNE's business considering any changes to the allocation of functions, assets and risks in the business.
- Whether each legal entity within the MNE performs the functions it was established for. For example, when an entity was established to perform a limited distribution function, does it now perform wider functions? Is the entity being remunerated in line with its characterization? For example, a limited risk distributor bearing no risks would not be expected to incur losses.
- Whether a further analysis has been undertaken in relation to the reallocation of functions, pricing, and any potential exit charges. This consideration is particularly important in the context of businesses that have had to shut down, scale back their operations, or outsource certain functions to third parties.
- Whether each legal entity within the MNE employs relevant employees with the capabilities to perform the required functions, and there is no duplication of functions in the case of centralized operations.
- An reassessment of development, enhancement, maintenance, protection, and exploitation (DEMPE) functions within the Group, and whether any royalty payments are paid to the entity performing the relevant DEMPE functions, and whether the royalty rate is in accordance with the arm's length principle.

(2) Review of existing intra-group funding and potential new financing arrangements

Due to the disruption in business, many entities within an MNE Group may require additional financial support (e.g. for working capital purposes, due to decreases in income) from related parties in other jurisdictions. In the case of material intra-group funding changes, any new arrangements need to be conducted at arm's length. Some key points that MNEs should consider in relation to their existing intra-group funding and potential new financing arrangements are as follows:

- Whether interest rates on existing loans should change. Given cash flow impacts to many MNEs'; entities, are existing intra-group funding arrangements still feasible? Could existing funding arrangements within MNEs still be considered at arm's length if any interest holidays have been applied? On this basis, should any existing intra-group funding arrangements be recharacterized?
- A review of the debt to equity ratio and interest deductibility rules in each of the MNE's relevant jurisdictions.

- A review of the credit ratings of borrowing entities in the Group. If the existing intra-group funding arrangements are based on a historical credit rating, the MNE Group should revisit or re-assess entity ratings following the pandemic.
- The provision of parental guarantees to MNE entities. Where parental guarantees were provided due to financial stresses brought about by the pandemic, it is important to ensure that suitable arm's length guarantee fees are in place.

(3) Review of supply chain model

Throughout the pandemic, countries took different approaches to lockdowns. Many jurisdictions had specific rules and restrictions towards other jurisdictions, and many countries imposed lockdown at short notice, bringing major disruptions to MNEs' supply chains. In order to mitigate such uncertainties in the future, we note that many MNEs have been reviewing their supply chains to ensure more resilience. With the potential closure of borders at any time and potential suspension of operations, MNEs need to have a shorter planning cycle in order to meet local demands.

The pandemic has accelerated the digitalization of supply chains and significantly increased e-commerce activity. In the 'new normal,' TP models need to adapt to new commercial realities and different types of related party transactions. It is expected that MNEs will modify their supply chain models in the medium to long term, which will directly impact the functional profile and potential profit levels of many entities within the supply chain. Given this context, a few issues that MNEs should contemplate with regards to their supply chain and TP arrangements include:

- Ensuring full stakeholder engagement when an MNE introduces a new supply chain model or new transactional flows. In these circumstances, it is critical that all relevant stakeholders are involved in evaluating any new intra-group transactions and ensuring that an appropriate functional analysis has been undertaken in order to plan the supply chain strategy and TP roadmap.
- Considering whether MNEs could create permanent establishments in jurisdictions where they currently have market presence, but no physical presence. In the ME, the creation of inadvertent permanent establishments remains a critical tax risk area liable to material exposures for many MNEs and brought about by operational changes from a reaction to the pandemic.

(4) Possibility of waiving any intra-group charges

Where local entities are incurring significant losses, MNEs may have considered waiving intra-group charges, e.g. applying interest holidays, or waiver of payments in relation to intangibles (e.g. royalties or tradename / trademark fees), in order to alleviate financial pressures on low profit or loss-making entities. However, such measures need to be considered carefully and from a two-sided perspective, i.e. not only

the perspective of the recipient of the waiver but also the recipient of the payments, and the tax and TP implications of such measures should be considered in detail to avoid any tax exposures.

(5) Consistency / uniformity of TP policies

With the introduction of formal TP rules in a number of ME jurisdictions, (e.g. most recently Qatar and Jordan and the progression of TP skills and knowledge by the local tax authorities), as well as a significant increase in transparency brought about through Country-by-Country reporting (CbCR), it is critical for MNEs to have consistent and uniform TP policies for their intra-group transactions across jurisdictions in the ME and globally.

Where there are any reallocation of functions, assets, and/or risks within the MNE, a robust analysis needs to be performed to cover the MNEs' overall operations. Furthermore, any potential adjustments or changes in MNEs' TP policies should be performed and applied towards all relevant entities within the Group. In this regard, additional considerations on changes to MNEs' TP policies include:

- Whether any year-end adjustments are needed in the case of modifications in TP policies.
- The consideration of the impact of any year-end adjustments on customs, Value Added Tax (VAT), and withholding taxes.
- Whether the Group has an Enterprise resource planning (ERP) system which can accommodate and monitor year-end TP adjustments.

(6) Robust TP documentation and supporting documents

With the rise of tax and TP audits in the region, it is essential to maintain contemporaneous TP documentation especially in jurisdictions with fully fledged TP requirements, i.e. Kingdom of Saudi Arabia (KSA), Qatar, Jordan and Egypt, including a Master File, Local File, and CbCR. CbCR is also relevant for Oman, United Arab Emirates (UAE) and Bahrain parented Groups bearing in mind the relevant thresholds.

In addition, intra-group agreements and proper TP policies should also be maintained by MNEs and local entities to support pricing arrangements. Any changes in TP policies should be reflected in changes to legal agreements.

Furthermore, there are TP disclosure form requirements in KSA, Qatar and Jordan (filed with tax returns), whereby in the recent past, we have seen tax authorities grant extensions to taxpayers due to the pandemic. Going forward, i.e. for FY21 to be reported in 2022, taxpayers should not rely on tax authorities to provide further extensions.

Conclusion: Ensuring readiness for the fast-evolving ME TP landscape

The tax and TP landscape in the ME has changed significantly in the last few years. Most MNEs no longer consider countries in the Middle East region to be 'low risk' jurisdictions. MNEs operating in the region now need to go a step further and proactively manage their tax and TP arrangements as they do in mature and developed tax jurisdictions.

Lastly, the Organisation for Economic Co-operation and Development (OECD) developments around a Global Minimum Tax have increased the possibility of corporate income taxes being introduced in some of the 'zero corporate income tax countries' in the region, e.g. the UAE and Bahrain. As such, now is the right time for MNEs to undertake holistic reviews of their operating models and ensure readiness considering all these regulatory and macroeconomic developments. That will undoubtedly leave many MNEs facing important decisions in the coming months.

Authors



Mohamed Serokh

Tax Partner – ME Transfer
Pricing Leader

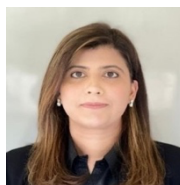
mserokh@deloitte.com



Joy Mukherjee

Director, Transfer Pricing
Kingdom of Saudi Arabia

jmukherjee2@deloitte.com



Rabia Gandapur

Director, Transfer Pricing
United Arab Emirates

rgandapur@deloitte.com



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