



## **Transfer pricing policy and design in the Middle East**

Whitepaper series | Volume 2

# Introduction to transfer pricing policy and design

There are a number of jurisdictions in the Middle East (for example the UAE or Bahrain) that possess not only low/zero tax rates but also provide access to other important economic factors, such as the ability to attract a skilled international workforce, making them a popular choice for a regional hub.

A robust transfer pricing policy can generate significant commercial benefits, especially if that policy is tailored to the unique footprint of a multinational entity (MNE). These benefits include:

- Minimized disputes with tax administrations (reduced transfer pricing adjustments, reduced internal resources allocated to audits and reduced spend on adviser fees);
- Minimized leakage (e.g. reduced withholding tax and permanent establishment challenges and adjustments – these areas of taxation law overlap with transfer pricing and a well-designed and documented policy can help to mitigate tax challenges in these areas also);
- A reduced need to maintain uncertainty provisions in financial accounts (this may provide an immediate earnings benefit to MNEs);
- Revenue enhancement and cost control (certain transfer pricing methods for particular entities/divisions can help to incentivize teams to look for opportunities to create value for the MNE (e.g. a sales/commission or profit split transfer pricing structure that will incentivize local entities to increase sales efforts and/or control costs more efficiently);
- Cash tax optimization (ensuring that substance in lower tax jurisdictions can support the level of taxable profits);
- Competitive advantages over rival MNEs that have not adopted an optimal transfer pricing and business model;
- The ability to attract and retain best in class international tax practitioners in-house due to a variety of transfer pricing planning initiatives rather than a reactive compliance-based approach to transfer pricing policy.

This transfer pricing whitepaper (the second in the series of Deloitte Middle East transfer pricing whitepapers) brings the above benefits together by considering both static and dynamic transfer pricing design models for MNEs operating in the region.

Volume 1 was issued earlier this year and discusses:

1. The results of an October 2018 transfer pricing survey for businesses operating in the region, and
2. Some helpful guidelines for businesses operating in the region that will assist in evaluating risks and opportunities

## **A general transfer pricing rule: more economic substance = more taxable profits**

For decades, MNEs have attempted to centralize substance in tax havens including Switzerland, Luxembourg, Singapore and even more 'exotic' locations. The Organisation for Economic Co-operation and Development (OECD) Base Erosion Profit Shifting (BEPS)<sup>1</sup> project changed the fabric of tax planning in the modern environment and underscored the importance of economic substance and robust support for principal/hub structures that seek to allocate profits to low tax jurisdictions.

However, despite the current compliance burden on MNEs as a result of BEPS regulations, the detailed guidance emerging from the OECD's lengthy consultation with tax administrations and MNEs has provided a useful framework for transfer pricing planning and design in terms of marrying substance with appropriate and relevant arm's length pricing.

### The United Arab Emirates (UAE) versus traditional hubs (e.g. Singapore and Switzerland)

There are a number of jurisdictions in the Middle East (for example the UAE or Bahrain) that possess not only low/zero tax rates but also provide access to other important economic factors, such as the ability to attract a skilled international workforce, making them a popular choice for a regional hub.

A number of MNEs have engaged Deloitte to validate the position of the UAE as an

Some anticipate a 5% corporate income tax on the coming years and as such are looking to see if the UAE is still a competitive location for investment.

international tax hub (some anticipate a 5% corporate income tax in the coming years and as such are looking to see if the UAE is still a competitive location for investment).

	UAE	Netherlands	Switzerland	Singapore	United Kingdom	Luxembourg
<b>Special holding company regime available</b>	No	No	Yes <sup>1</sup>	No	No	Yes <sup>2</sup>
<b>Advanced ruling available</b>	No	Yes	Yes	Yes	Yes	Yes
<b>Substance requirements</b>	Yes	Yes	Yes	No <sup>3</sup>	Yes	Yes
<b>Number of jurisdictions with active tax treaties</b>	90	94	107	86	129	82
<b>Controlled foreign corporation ("CFC") rules or equivalent legislation</b>	No	Yes <sup>4</sup>	No	No	Yes <sup>5</sup>	Yes <sup>6</sup>
<b>Headline CIT rate</b>	0%	19%/25% <sup>7</sup>	12% - 24% <sup>8</sup>	17%	19% <sup>9</sup>	17% <sup>10</sup>
<b>Domestic WHT rates on:</b>						
- Dividends	0%	0% / 15%	35%	0%	0%	0% / 15%
- Interest	0%	0%	0%	15%	0% / 20%	0%
<b>Transfer pricing rules</b>	No	Yes	Yes <sup>11</sup>	No	Yes	Yes
<b>Thin capitalization rules</b>	No	Yes	Yes	No	Yes	Yes

1. Holding companies are, in principle, exempt from any cantonal tax on income and pay only a reduced cantonal tax on capital. Holding companies may qualify for the income tax exemption as long as their participation (or the derived income) represents at least two thirds of their total assets (or of their total income). The Swiss parliament has approved legislation (that also may potentially be subject to a public referendum) that would abolish the holding company regime from 2020, although investment income would continue to benefit from a participation exemption regime.
2. An SPF ("société de gestion de patrimoine familial") is exempt from corporate income tax, municipal business tax and net worth tax. The activities of an SPF must be limited to the acquisition, holding

- and management of financial assets (including cash, bonds, shares and commodities) held in an account with a professional financial service provider. An SPF is not allowed to perform any commercial activities, and must limit its involvement in its shareholdings to the exercise of its shareholder rights. An SPF is not allowed to grant interest bearing loans (to a limited extent it may grant interest free advance payments to subsidiaries). Due to the limited scope of its activities and to the explicit prohibition to carry out a commercial activity, the SPF qualifies as a passive investment vehicle.
3. A general anti-avoidance rule exists in the legislation to disregard the tax effect of arrangements entered into with a primary or dominant purpose of obtaining a tax benefit.

4. In case a Dutch corporate taxpayer has a direct or indirect interest of more than 50 per cent in a low-taxed foreign subsidiary (a controlled foreign company: CFC) or has a low-taxed permanent establishment, the CFC rules will be applicable.
5. A charge applies to UK resident companies with certain prescribed interests (broadly, at least a 25% interest but also now, together with associated enterprises, an interest of more than 50%) in controlled foreign companies (CFCs). The CFC charge operates by means of an apportionment of the CFC's chargeable profits to the relevant UK companies.
6. In case a Lux corporate taxpayer has a direct or indirect interest of more than 50 per cent in a low-taxed foreign subsidiary (a controlled foreign company: CFC) or has a low-taxed permanent

establishment, the CFC rules will be applicable.

7. Taxable income up to EUR200,000 subject to 19% and over such amount is taxable at 25%.
8. Federal tax rate of 8.5% but additional cantonal income tax applies with rates that vary depending on location.
9. The main rate of corporation tax is 19%, reducing to 17% as from 1 April 2020. The main rate does not apply to "ring fence" profits from oil rights and extraction activities.
10. 17% general rate. 18.19% is effective rate (including 7% surcharge) or 24.94% for Luxembourg City (including 7% surcharge and 6.75% municipal business tax).
11. No formal transfer pricing rules. Switzerland follows OECD transfer pricing guidelines and introduced CBC reporting as from January 2018.

The UAE has moved ahead of Luxembourg and is closing in on the UK when the comparison is honed down to global financial centers attracting FDI.

Aside from the international tax attributes, the UAE has featured highly in independent research studies in recent years:

#### UNCTAD – Top 30 jurisdictions for FDI

The United Nations Conference on Trade and Development (UNCTAD) report on World Investment for 2018<sup>2</sup> confirmed that more than 25% of the world's 500 largest companies already have the UAE as the regional base of their operations in MENA (Middle East North Africa). In addition, the UAE is ranked 30th (globally) in terms of the quantum of foreign direct investment (FDI) inflows (rising five positions from 2017 and continuing to move up this prestigious list). The UAE has moved ahead of Luxembourg and is closing in on the UK when the comparison is honed down to global financial centers attracting FDI - there is still some work to be done to catch Switzerland and Singapore as financial centers, but those jurisdictions have had a head start on the UAE as show on the left.

#### World Bank – ranked 11th for ease of doing business

The World Bank 2018/2019 Ease of Doing Business study witnessed the UAE. climb 10 places from the previous year to rank 11th out of 190 business hubs. The World Bank study confirmed that "The UAE. has become a global hub for innovation, entrepreneurship and investment."

#### IMD – Top 5 competitiveness ranking

The UAE was ranked number 5 in the recent (April 2019) IMD World Competitiveness Ranking (Singapore, Switzerland and Hong Kong were also in the top 5 alongside the USA).

#### World Investment Report 2018 total FDI inflows – Financial centers



Global Power Index – top 30

A separate Global Power City Index released in October 2018 placed Dubai as a city at position 29 in the World (ahead of Geneva, Paris and Boston).

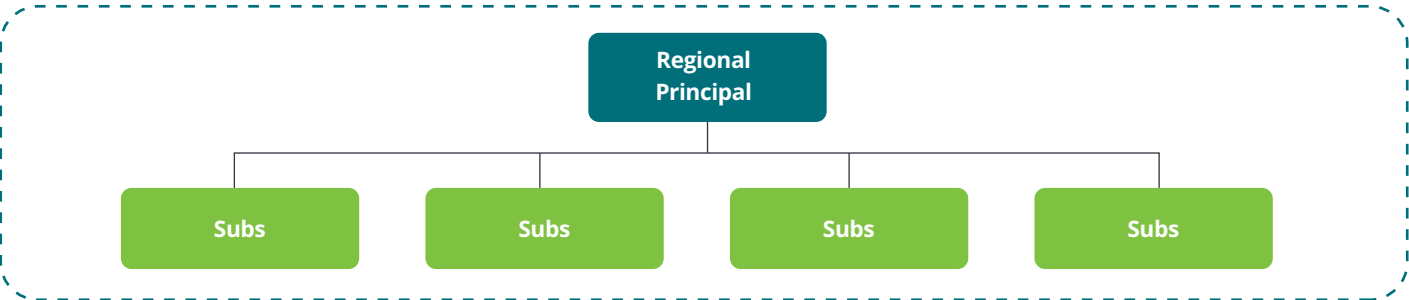
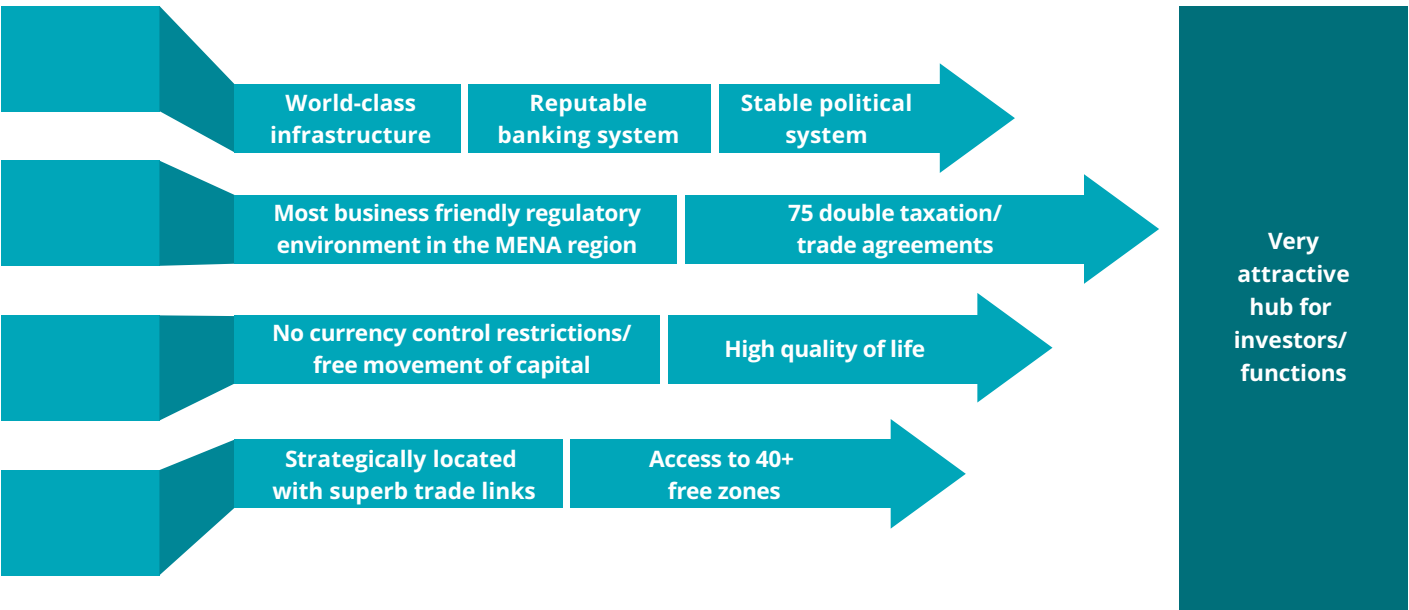
What do the above studies indicate for the UAE?

Given the healthy economic environment as attested to by the above independent research studies, MNEs that are operating in the region are likely to have already built up significant economic substance in the UAE. We are partnering with these businesses to unlock significant opportunities through transfer pricing planning and design. In addition to MNEs already operating here, global MNEs considering investment (or expanding

current investment) in the region or locally headquartered MNEs looking to expand/consolidate globally should all consider the importance of the UAE as a principal/hub (discussed in more detail later in this whitepaper).

This whitepaper considers two key transfer pricing design policies/strategies for MNEs operating in the region:

- 1. Static policy: The design and selection of a transfer pricing policy around the existing fact pattern of the MNE
- 2. Dynamic policy: A transfer pricing design built around commercial and organizational changes that are taking place within the MNE



# 1. Static transfer pricing design – Low risk, medium to high reward

Do not rush to document a transactional net margin method-based local file as you might overlook significant cash tax optimization opportunities; always start with a re-design or validation of the existing transfer pricing policy.

The low hanging fruit for MNEs operating in the region (particularly those with substance already in low tax locations) will be to assess the current intra-group transactions in place and to consider different pricing options/models for the MNE. Do not rush to document a transactional net margin method-based local file as you might overlook significant cash tax optimization opportunities; always start with a re-design or validation of the existing transfer pricing policy.

The following three steps will be helpful for MNEs before they reach the Action 13 documentation phase:

## **I. Review and delineate actual transactions with respect to economic value and benefit**

Some intra-group transactions create significant value for the group and other intra-group transactions provide only incidental or minimal benefit. It is important to identify and delineate all the intra-group transactions in place to assess what value they create and what risks they assume before agreeing on an appropriate transfer pricing policy. By way of example, it came to light in a recent review that one of our clients based in the UAE has, for many years, been providing local operating subsidiaries with access to intellectual property and also guarantees on third party bank debt to assist the local subsidiaries to obtain finance. No transfer prices have been charged to date and it is important to ensure that the UAE entity is

remunerated at arm's length for the value of these services provided, if indeed they have value to the subsidiaries. Note that this value should be based on detailed economic analysis with reference to local regulations (in the territories making intra-group payments).

If it is found that the local subsidiaries do not receive economic benefit, then no payment should be made at arm's length but one must assess this in advance of the setting of prices and documentation of those prices as it could unlock significant value for the MNE whilst ensuring compliance. There are countless other examples of untapped opportunities due to the focus of MNEs and their advisers on documentation and compliance rather than looking at a broader planning and design-based approach.

## **II. Consider the non-fiscal benefits of transfer pricing policies**

Transfer pricing policies can be based on costs, sales or profits and each of these has various implications for the MNE with respect to incentivizing local teams/divisions/entities to control costs and/or enhance revenues. Note that changing the transfer pricing policy should be considered where appropriate rather than dogmatic adherence to an aged policy year on year. The following table sets out some important considerations with respect to the choice of transfer pricing policy:

Type of transfer pricing policy	Risks	Commercial benefits
<b>Profit based</b>	May not be widely understood by tax administrations in the region	Incentivize local teams to enhance revenue and control costs for the MNE
<b>Sales based (e.g. commission on adjusted sales, license fees, etc.)</b>	Low risk method that should be supportable with robust economic analysis	Incentivize local teams to enhance revenue for the MNE
<b>Cost based (e.g. basic mark-up on adjusted costs)</b>	Low risk method that should be supportable with robust economic analysis	Simple from an administrative perspective and may afford protection to local operating companies in terms of a stable profit margin

### III. Overall risk management and certainty options

Many MNEs adopt 'measured' transfer pricing policies in locations in which transfer pricing audits are incessant (e.g. Australia, Germany and India). This is to reduce detection risk (the likelihood of a case/transaction being selected for audit). Note that this may lead to an above arm's length result in these locations (and risk in the corresponding location/s); however, such a strategy may help to balance the overall transfer pricing risk for the MNE.

Transfer pricing certainty rulings (advance pricing agreements) will become more readily available in the coming months and years; Deloitte is working with tax administrations in the region to help draft regulations and guidance that will help MNEs enter into transfer pricing agreements with tax administrations.

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## 2. Dynamic transfer pricing design – Medium risk, high reward

Developing a transfer pricing policy that is not based on the commercial facts and operations of an MNE runs the risk of curtailing the bottom line, and a business model that does not take transfer pricing into account may end up surrendering some or all of the profit it creates to tax administrations.

It is critical for MNEs to redesign their transfer pricing policies when the business is encountering change. It is helpful to consider such changes along the following **A-B-C-D-E** triggers:

- **A** Mergers and **A**cquisitions (structural changes to the MNE)
- **B** Business expansions (new products and/or new markets)
- **C** Carve outs (new framework for an independently owned/managed business)
- **D** Disruption in the market/economy triggering the need for cost control, centralized approaches
- **E** ERP implementations (significant changes to the automation, reporting and cost structure of an MNE)

Note that we have also been asked to look at transfer pricing design due to commercial changes that MNEs operating in Qatar are witnessing as a result of the economic blockade.

### Value Chain Alignment (VCA)

The alignment of a multinational company's operating model and its global tax objectives through the A-B-C-D-E triggers set out above is an important step in enhancing corporate profitability and shareholder value. Business leaders often have to make tough choices when faced with competing priorities such as competitive pressure in the market and the internal desire for growth, regulatory constraints, and increased public scrutiny.

Currently, these challenges are compounded by the uncertainty of a changing landscape of transfer pricing regulations under the BEPS project, which is bringing widespread regulatory changes across many territories in the region.

Increased public transparency and new compliance obligations such as country by country reporting (CbCR) will also present fundamentally new challenges for multinationals operating across multiple territories.

Deloitte refers to changes in MNE operating policy alongside the tax and transfer pricing considerations as VCA and this requires the tax function at an MNE to work closely with other areas of the business. The OECD refer to this as "business restructurings" – see Inset I (below).

### VCA Challenges to Address

- Opportunities for reducing costs and revenue enhancement through standardization and harmonization of processes and the implementation of business process improvements;
- The shifting regulatory landscape, CbCR and increased transparency;
- Collaboration and communication among the MNE divisions (sales, marketing, operations, IT, legal, HR, finance and tax);
- Potential impacts on external and contractual relationships and how to manage change;
- Harmonization of different IT systems and master data;
- Change resistance within the MNE; and
- Direct and indirect taxation alongside transfer pricing design.

Operational changes are usually required to change the business model; however, designing a new operating model to improve operating margins and grow revenues in a transfer pricing compliant manner can generate increased after tax earnings and enhanced cash flows for the MNE. This needs to be managed carefully



with a command and control project management structure, strong communication, and dynamic change management.

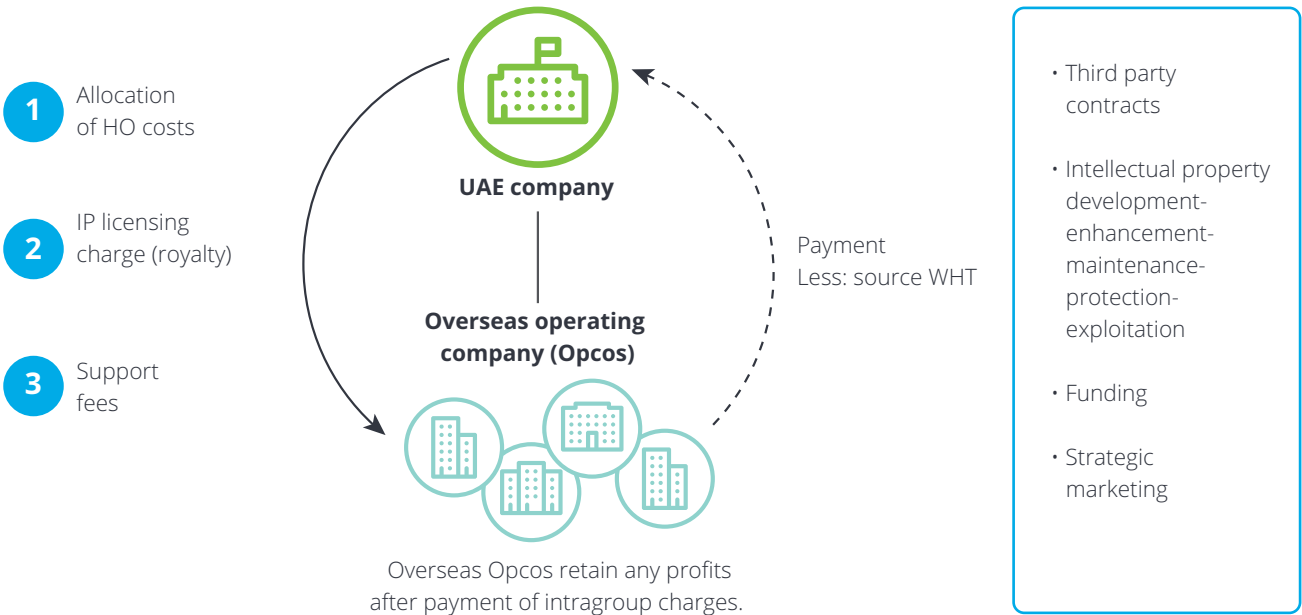
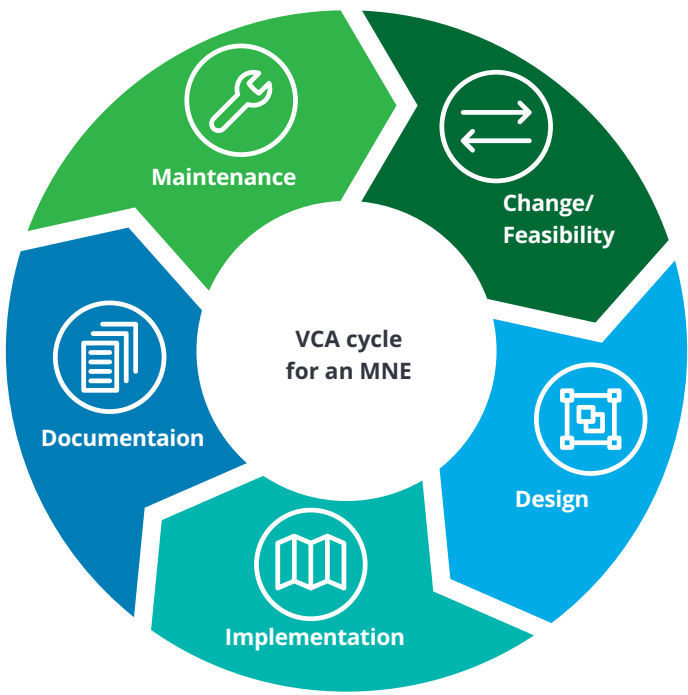
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**VCA example - Basic Regional Hub/Principal Model**

The Regional Principal structure is a robust and viable model applied by many MNEs to achieve value creation for the business alongside transfer pricing compliance.

Economic substance in a Regional Principal will include head office functions and strategic oversight (e.g. for research, sales, marketing, intellectual property, treasury and other functions). The Regional Principal may earn third party revenues (via third party contracts) and be in receipt of arm's length intra-group fees in return for the services provided (see table below).

The VCA cycle for an MNE



## INSET I: Precedents to support dynamic transfer pricing design

“MNEs are free to organize their business operations as they see fit. Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations.”

Transfer pricing design around business restructuring has support in local regulations, global standards and international case law:

### **Support from the OECD for business restructuring and transfer pricing design**

The OECD transfer pricing guidelines define business restructurings for the purposes of transfer pricing as “cross-border reorganization of the commercial or financial relations between associated enterprises...Relationships with third parties (e.g. suppliers, sub-contractors, customers) may be a reason for the restructuring or be affected by it”.

Chapter IX of the OECD transfer pricing Guidelines confirms that there must be:

1. Valid business reasons in place for any restructuring that will result in an allocation of profits to a lower tax jurisdiction; and
2. The arrangement must be arm's length at the level of each individual taxpayer (i.e. not just the MNE as a whole that may have obtained a cash tax advantage from a restructuring).

Chapter IX also confirms that “MNEs are free to organize their business operations as they see fit. Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations.”

### **Support from the UN for business restructuring and transfer pricing design**

The tone of the United Nations (UN) Practical Manual is more supportive of transfer pricing advisory, design and planning, whereas the OECD BEPS project has approached guidance in many areas as a response to aggressive tax planning. The UN Practical Manual has the following comments in this regard:

- Successful MNEs use location and internationalization advantages to maximize the share of global markets and growth. They are able to minimize costs through integration economies that are not available to domestic firms;
- In order to optimize the value chain, MNEs may establish new business operations in a developing country (in the establishment of infrastructure, improvement of the education of individuals and provision of economic benefits to the country);
- Tax authorities should not start from the assumption that MNEs are manipulating their results in order to obtain tax benefits. Many MNEs have published codes of conduct and a set of transfer pricing principles requiring the MNE to comply with the tax legislation;
- In many cases, MNEs have an incentive to set an arm's length price so as to judge performance on an equitable basis. The UN Practical Manual reiterates that it should not be an implicit assumption that there is profit manipulation.

Note that many jurisdictions in the region have adopted the OECD BEPS inclusive framework; however, the UN Practical Manual on transfer pricing for Developing Nations continues to be an important influence on local regulations for the region also.

### Case law support for business restructuring

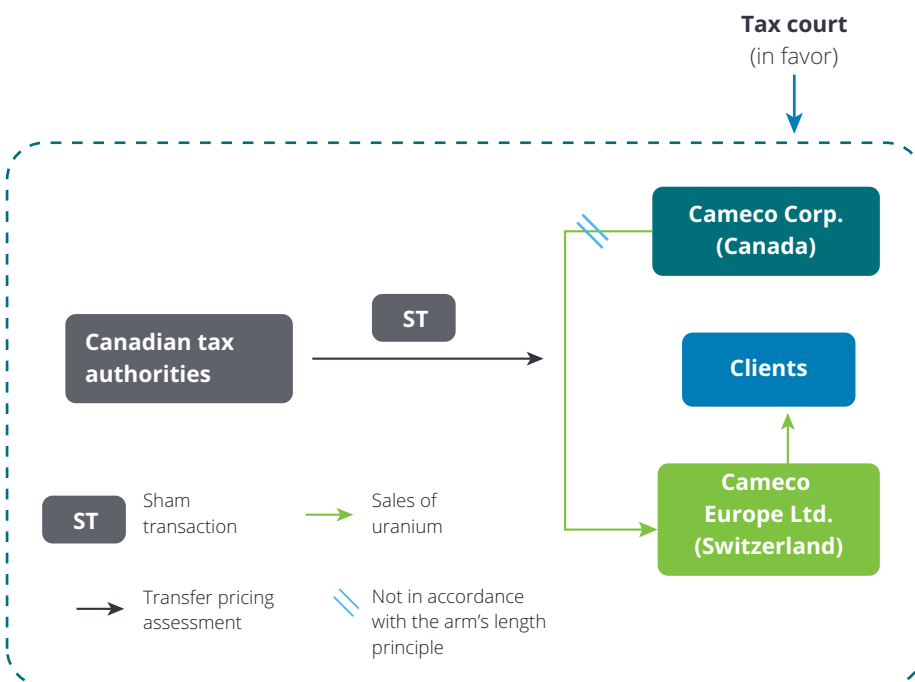
International case law with respect to transfer pricing economics will be relevant to the interpretation of regulations in all territories that apply the OECD economic principles and standards. In this regard, the 2018 Cameco case (outlined below) demonstrates that a sound economic and legal structure with arm's length pricing should be supportable despite any incidental cash tax savings.

It is important to note that Deloitte is not advocating the interposition of a territory such as the UAE purely for tax purposes, rather we are advocating the centralization of economic substance in the UAE as part of an MNE's current commercial policy for expansion in the region.

The Canadian mining company, Cameco Corp. (CC), sells uranium to a wholly owned trading hub, Cameco Europe Ltd. (CEL). CEL is registered in Switzerland and subject to tax at a lower rate. CEL re-sells the uranium to independent buyers and is highly profitable in doing so. The Canadian Revenue Authority argued that this was a "sham" transaction with no commercial basis. However, the Canadian court ruled that a sham transaction requires an element of deceit whilst this was a

commercial/legal structure and in all essence "the legal foundation of a tax plan". The court also ruled that this was a commercially rational structure and a re-characterization may only apply where arm's length parties would not have entered into the transaction or series on any terms or conditions but instead would have entered into an alternative transaction or series. The court further cautioned that comparability analysis lies at the heart of the transfer pricing rules and, as a result, any alternative transaction or series identified must be constructed with due regard for all the relevant circumstances in which the actual transaction or series was entered into. The transfer pricing analysis in place was considered to be robust and in line with the OECD guidelines.

Note that the above case illustrates the importance of a structured and methodical policy.



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## INSET II: Commercial rationale and substance

Deloitte advocate the centralization of economic substance in the UAE as part of an MNE's current commercial policy for expansion of the region.

Whether an MNE adopts a static or dynamic transfer pricing policy, it will be important to demonstrate that there is underlying economic substance (and non-fiscal benefits) to support the transfer prices applied.

### International guidance

The 2010 OECD Permanent Establishment (PE) report has continued to provide a useful body of guidance for economic substance and transfer pricing with broader application than allocating profits to PEs. The report confirms that: "A functional and factual analysis, conducted in accordance with the guidance found in the guidelines, must be performed in order to hypothesise appropriately the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks, and entering into dealings with each other and transactions with other related and unrelated enterprises. Under the first step, the functional and factual analysis must identify the economically significant activities and responsibilities undertaken by the PE."

The report introduced the concept of economically significant activities and significant people functions (SPFs) which has parallels with the key entrepreneurial risk taking (KERT) functions still applied in OECD Guidance for Financial Services. The OECD work in this area is extensive and broken down by sector and SPFs. The following examples have been gleaned from the OECD report by way of illustration of economic substance:

- Assumption of risks;
- Acceptance and management of risks;
- Economic ownership of assets;
- Active decision-making with regard to the

taking on and management of individual risk and portfolios of risks;

- Activities performed at a high strategic level by senior management or by a combination of centralized and devolved decision-making functions (however this should not just be saying yes or no to a proposal, i.e. economic ownership may also often be determined by functions performed below the strategic level of senior management); and
- Managing surplus cash and investments.

### Action 5 Core Income-Generating Activity (CIGA)

In November 2018, a new Action 5 Global Standard was announced for BEPS inclusive framework jurisdictions to prevent business activities from being relocated to no or only nominal tax jurisdictions to avoid the substantial activities requirement that applies to preferential regimes for geographically mobile income. These substantial activities are confirmed to include (but not be limited to):

- Headquarters,
- Distribution centers,
- Service centers,
- Financing,
- Leasing,
- Fund management,
- Banking,
- Insurance,
- Shipping,
- Holding companies, and
- The provision of intangibles.

The Global Standard confirms that the activities should be undertaken in the location in question and employees/expenditures related to the activities should be adequate and identifiable. Action 5 regulations are expected in multiple territories in the region in 2019.

## INSET III: Case studies

### A locally headquartered MNE

A UAE-based MNE engaged Deloitte in 2019 to redesign the transfer pricing policy to combine static and dynamic models. This was a board-level initiative that required close communication between all areas of the business and investors.

The MNE landed on a preferred transfer pricing policy after 2-3 months of intensive fact finding, analysis and consultation with Deloitte over the various credible design options. The key benefits of the new policy and structure adopted are as follows:

1. Reduces exposure to transfer pricing adjustments in local operating territories through a more stable local reward in these territories commensurate with the level of economic activity;
2. Validates the optimality of the current structure with the UAE as a regional principal compared to other potential options (e.g. Singapore).

### A globally headquartered MNE operating in the region

A global MNE operating in the region engaged Deloitte in 2019 to redesign the transfer pricing policy for a more dynamic model anticipating expansion into new markets.

The MNE has embarked on the implementation phase after a one-month design and feasibility review to set out the various options. The key benefits of the new policy and structure once implemented will be as follows:

1. Takes into account proposed business expansions into Asia-Pac and Africa (the policy involves changes to third party contracting in territories to reduce in-

Whether an MNE adopts a static or dynamic transfer pricing policy, it will be important to demonstrate that there is underlying economic substance (and non-fiscal benefits) to support the transfer prices applied.

- country revenue but provide a stable profit margin for loss-making entities that are in need of support for two to three years in a 'market penetration' phase);
2. Reduces revenue in local territories through a principal contracting structure that will help reduce cash tax leakage from high turnover taxation; and
3. Recognizes and does not overstate the importance of regional support compared to global support.

# Conclusion

Experience has shown that the potential cash tax savings of a robust and tailored transfer pricing policy are significant whilst ensuring compliance with BEPS regulations released in the Middle East and reduced transfer pricing audit challenges and adjustments.

There is a tendency in the region for MNEs and advisers to rush straight into Action 13 documentation preparation without considering the current transfer pricing policy and, in particular, whether the current policy is in harmony with the commercial objectives of the group for the existing fact pattern and for growth/expansion.

Local headquartered MNEs building a new transfer pricing structure and global MNEs investing in the Middle East should both look to take advantage of natural and commercial optimization opportunities given the level of substance they may possess in low tax locations such as the UAE, Bahrain and Qatar.

Any and all business change/transformation (A-B-C-D-E triggers) should also precipitate a review of the transfer pricing policy to maximize the opportunities for an MNE.

Experience has shown that the potential cash tax savings of a robust and tailored transfer pricing policy are significant whilst ensuring compliance with BEPS regulations released in the Middle East and reduced transfer pricing audit challenges and adjustments.

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