Transfer Pricing In Egypt – at a Glance

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1. Introduction To Transfer Pricing in Egypt

- As part of the Tax Reforms in Egypt the Transfer Pricing (TP) rules were introduced back in 2005 for the first time in according to the provisions of Income Tax Law 91 for 2005.

- Related Parties Transactions (RPT) were always one of the a controversial issues between the triangular Parties of the Egyptian Taxation System (i.e. The Taxpayers, Tax Advisors & Tax Inspectors). Each Party has had its own understanding, judgement and approach in dealing with it.
  - Taxpayers never have had internal rules on reviewing the (RPT) for Tax purpose, unless in minor cases, they had to do it due to requirements of the Parent Company which is located at a Jurisdiction that has TP rules.
  - Tax Advisors were only concerned with (RPT) to the extent that is mandated by the Egyptian GAAP or International Financial Reporting Standards (IFRS).
  - Tax Inspectors have had used their own interpretations and approaches (almost every one on his own), to deal with and judge the effect of the (RPT) on an individual Taxpayer.

As a result, Taxpayers used to receive huge and unjustifiable “unfavourable Tax Adjustments”.

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1. Introduction To Transfer Pricing (cont…)

- In general, the Income Tax Law stresses on that all Related Parties are to conduct their own transactions at Arms’ Length, by applying a “Fair Pricing“ to all these transactions.
- Although TP has been enforced by Law back in 2005, the Egyptian Tax Authority had not issue enough Regulatory Framework on the application of the TP Methods and procedures until recently.
- By the end of Q4 2010, the Tax Authority has issued the first set of TP Guidelines.
- The Guidelines are setting up a Regulatory Framework on vital issues of TP such as Arm’s Length Principles, Pricing Methods, Documentation, etc...
2. Legislation and Regulations

The following are the core Legislative Regulations of TP in Egypt:

- **Income Tax Law**
  - According to Article 30 of Law 91 for 2005, Related Parties should conduct all transactions at Arm’s Length.
  - Tax Authority shall have the right to adjust the prices of any transaction that it deems not at Arm’s Length.
  - The Tax Authority may agree in advance with Related Parties on the method(s) of pricing their transaction.

- **The Executive Regulation of the Law**
  - The Executive Regulation of the Law has specified the following three main methods to test the Fair Pricing:
    1. Comparable Uncontrolled Price (CUP)
    2. Resale Price (RP) or;
    3. Cost plus (CP).
  - However, the priority was given by the Executive Regulation to the first method to be generalized in testing all transactions.
2. Legislation and Regulations (cont…)

- **The Transfer Pricing Guidelines:**
  - Although Egypt is not one of the Organization for Economic Co-operation and Development (OECD), the Egyptian Tax Authority had, to a great extent, follow the OECD’ TP Guidelines to set-up its own TP Guidelines.
  - The Guidelines have ruled up the following:
    1. Arm’s Length Principles and its practical applications;
    2. Comparability Analysis;
    3. Pricing Methods and
    4. Documentation.
  - Due to the fact that TP, in practice, is not a “one-rule-fits-all-situations”, we expect that more in-depth guidelines might be issued by the Tax Authority to fit special industries and factual business cases.
3. Terminology to Know

- **Transfer Pricing - TP**
  Is the exchanged transactions between Controlled *Related / Dependent Parties* that involve different deals between those parties (e.g. sale of goods, render of services, management fees, intangibles, services charging, raising of finance etc.). TP rules assume transactions between related parties are executed at arms’ length conditions with a full transparency.

- **Arm’s Length Concept**
  - As per Egyptian Law’s definition “the Arm’s Length Price is that upon which two or more independent / related parties deal. This Price is determined according to market forces and the related transaction condition”.
  - As per the OECD definition according to Article 9 of the OECD Model Tax Convention “where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not accrued, may be included in the profits of that enterprise and taxed accordingly.”
3. Terminology to Know (cont…)

- **Related Parties**
  
  General Definition: “Those Parties that control or have a significant influence over an entity (including Parents, Owners, major Investors and/or Key Management Personnel) as well as parties that are controlled or significantly influenced by an Entity (including Subsidiaries, Joint Ventures, Associates, etc.,)”

  According to Egyptian Income Tax Law” any person who has a relationship with a taxpayer that has an effect /effects on the taxpayer’s net taxable profit. Those relationships could take one of the following forms:

  1. Family members.
  2. A corporation in which the RP owns, directly or indirectly at least 50% of the shares or voting power.
  3. Partnerships and their partners; and / or
  4. Parent companies and subsidiaries in which the parent company holds a stake not less than 50%.

- **Comparability Analysis**
  
  OECD Definition: “Is a comparison of a controlled transaction with an uncontrolled transaction or transactions. Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g. price or profit margin), or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

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4. Methods of Transfer Pricing

The Egyptian TP Guidelines applies the same Methods as stipulated by the OECD, as follows:

1. Traditional Transaction Methods:
   a) **Comparable Uncontrolled Price Method (CUP)**
      OECD Definition “A transfer Pricing method that compares the price for property or service transferred in a controlled transaction to the price charged for property or service transferred in a comparable uncontrolled transaction in comparable circumstances.”

      Consideration of applicability:
      - Legal conditions of each party of the transaction
      - Market conditions and circumstances
      - Surrounding Economical Conditions
      - No material differences would occur as a result of the comparison
      - In case of differences, an adjustment could be made to eliminate any material differences.
4. Methods of Transfer Pricing (cont…)

b) **Resale Price Method (RP)**

OECD Definition “A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded after adjustment for other costs associated with the purchase of the product (e.g. Customs Duty), as an Arm’s Length price of the original transfer of property between associated enterprises.”

Consideration of applicability:

- Less product comparability is more required under the RP method than under the CUP method.
- The comparability of functions performed, assets used and risks assumed must be analysed.
- The lower the value added by the reseller to the product the easier the application of RP method.
- The shorter the time period between the purchase date and the resale date, the more accurate the result is likely to be.
- The direct relationship between the amount of the resale price margin and the level of the activity performed by the reseller must be considered.
4. Methods of Transfer Pricing (cont…)

c) **Cost Plus Method (CP)**

OECD Definition “A Transfer pricing method using the costs incurred by the supplier of property or service in a controlled transaction. An appropriate cost plus mark-up is added to this cost to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost plus mark-up to the above costs may be regarded as an arm’s length price of the original controlled transaction.”

Also OECD defines CP as “A mark-up that is measured by reference to margins computed after the direct & indirect costs incurred by a supplier of property or service in a transaction.”

Consideration of applicability:

- The uncontrolled mark-up used to determine an arms length mark-up for controlled transactions must be those realised by enterprises performing similar functions and preferably selling similar goods to independent parties.
- Differences between the controlled transactions and the selected comparable uncontrolled transaction that can materially affect the growth mark-up should be accounted for.
- Deeply analyse comparability factors which are expected to significantly affect the CP mark-up of a particular transaction.
- Accounting, consistency and a comparable cost basis (cost and expenses could be classified as direct cost, indirect costs and operating expenses)
4. Methods of Transfer Pricing (cont…)

Summary of Traditional Transfer Pricing Methods:

<table>
<thead>
<tr>
<th>Method</th>
<th>Attribute</th>
<th>Product Comparability</th>
<th>Functional Comparability</th>
<th>Comparable Party</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP</td>
<td>Price</td>
<td>Highly required</td>
<td>Highly required</td>
<td>Supplier/ or distributor</td>
</tr>
<tr>
<td>RP</td>
<td>Gross Margin</td>
<td>Less</td>
<td>Highly required</td>
<td>Distributor</td>
</tr>
<tr>
<td>CP</td>
<td>Gross mark-up</td>
<td>Less</td>
<td>Highly required</td>
<td>Supplier</td>
</tr>
</tbody>
</table>
4. Methods of Transfer Pricing (cont…)

2. Transactional Profit Methods

It depends to a great extent on the profit arising from controlled transaction, which used to judge whether the transactions were affected by conditions that differ from those that would have been made by independent enterprises in otherwise comparable transactions. In other words these methods examine the profits that arise from particular controlled transactions.

a) Profit Split Method (PSM)

This method could be suitable in case transactions are interrelated and can not be judged on separate basis. This method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction. This method could be worked out through out splitting of the profit by either of the following approaches:

1. Contribution analysis approach, (total operating profits from controlled transaction to be split between two enterprises based on a relative value.

2. Residual Profit Split Approach, (dividing operating profits in two stages:
   2.1. Basic returns determined by reference to the market returns of each RP
   2.2. Residual profits would be allocated among the RP based on the analysis of circumstances that might indicate how this residual would have been divided between these RPs.

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4. Methods of Transfer Pricing (cont…)

b) **Transactional net Margin Method (TNMM)**

It operates in a manner similar to the Cost Plus (CP) and Resale Price (RP) methods as it requires a level of comparability similar to that needed for the application of the CP and RP methods. There are two steps for applying the TNMM, as follows:

1. Comparing the net profit margin realized by the Taxpayer in a controlled transaction with the net profit margin realized by the same taxpayer or by an independent enterprise in a comparable uncontrolled transaction and;

2. Examining the net profit margin relative to an appropriate base such as costs, sales or assets.
4. Methods of Transfer Pricing (cont…)

Preferred Method

Would both the Traditional Transaction Method and Transactional Profit Method apply Equally and Reliably

Yes

Use the Traditional Transaction Method

No

Use the Transactional Profit Method

Would the CUP Method and other TP Traditional Method apply Equally and Reliably

Yes

Use the CUP Method

No

Use the ever appropriate Method

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5. Disclosure Requirements & Documentation

a) Disclosure Requirements:
By Law, all transactions carried out by related parties have to be properly disclosed by the Taxpayers. Disclosures of those transactions might be through the Tax Declaration, Financial Statements as well as the accounting records.

b) Documentations:
The Egyptian Tax Authority suggested what it calls “Four-Steps Approach” which basically emphasises the following:
1. Identifying Intra-group Transactions supports (e.g. Organizational Structures, business lines and unites, business relationships, business models, object of the transaction, etc.),
2. Supports of the selected most appropriate TP method (e.g. basis of the selections, analysis done to support the selection, examples and illustrations etc.),
3. Applying the selected method (bases of comparability studies done, calculations made for applying the method, analysis of the causes of the suitability of the selected method, etc.),
4. Determining the Arm’s Length amount and introducing a renew process to collect any future changes (e.g. the established arm’s length amount, actions taken to monitoring any changes in the circumstances of the Related Parties of the transaction, evaluation of the effect of any changes, adjustments needed, etc.).
6. Advanced Pricing Agreements (APAs)

In general, according to the Egyptian Income Tax Law and its Executive Regulation, the Tax Authority may agree in advance with Related Parties on the method(s) of pricing their transaction. The Taxpayer has to notify the Tax Authority with the following (or any other supports the Authority might request):

- Detailed description of the transaction
- Details of the related parties of the transaction
- Expected tax consequences
- Copies of all supporting documents that deemed necessary (e.g. contracts, analysis, financial information, projections etc.).

The Authority shall respond to the Taxpayer’s request within 60 days and shall be committed with its decision (unless otherwise it discovers any undisclosed facts on the transaction that materially negatively affects its judgements based on which the decision is taken).

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7. Prescription Period / Statue of Limitation

The Tax Authority’s right for adjustments might be collapsed as follows:

- Five years from the date determined by the Law as a “deadline” for filing Tax Returns.
- Six years from the above date in cases where strong evidence of “Tax Evasion” by Taxpayer is determined by the Tax Authority.
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