

Global Transfer Pricing Landscape

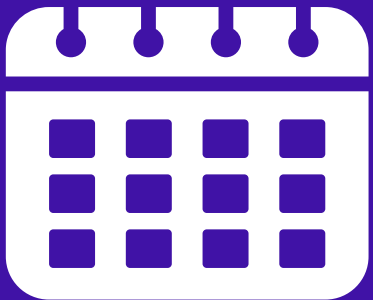
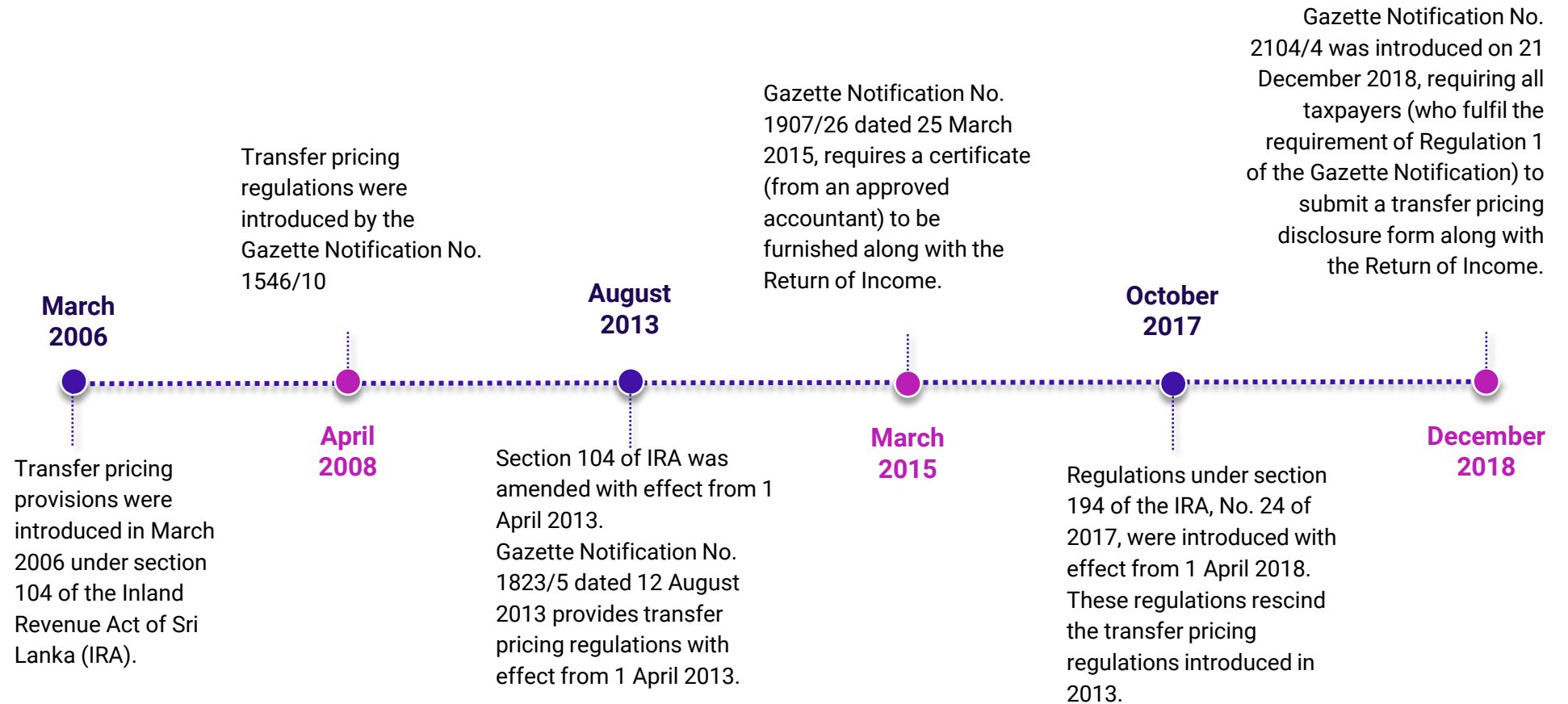
Sri Lanka

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Highlights



Introduction

Section 76 and 77 of IRA empowers the Commissioner General (CG) to ascertain the arm's length price (ALP) in any transaction entered into between two associated undertakings.

In case the income or the loss has not been as ascertained with regard to the ALP, the CG may estimate the amount of the profit and income or the loss and make an assessment. Accordingly, the CG has powers to re-compute or adjust the income and may impose a tax liability on the undertaking.

In August 2013, transfer pricing regulations were published by the Finance Minister of Sri Lanka through a gazette extraordinary. As per the gazette, all international transactions between associated undertakings were required to be conducted on an arm's length basis.

Associated Enterprises (AEs)

Two enterprises shall be deemed to be AE if the following conditions are satisfied:

- a) Any person or enterprise holds, directly or indirectly shares or otherwise carrying the majority of the voting power in the other enterprise;
- b) Any person or enterprise holds, directly or indirectly, shares carrying **not less than 50%** of the voting power in each of such enterprise;
- c) Loans advanced by one enterprise to another enterprise **not less than 51%** of the book value of the total assets of the other enterprise;
- d) Loans and equity provided by one enterprise to another enterprise **not less**

than 51% of the book value of the total assets of the other enterprise;

- e) One enterprise guarantees **not less than 25%** of the total borrowings of the other enterprise;
- f) More than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise;
- g) More than half of the board of directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises, are appointed by the same person or persons;
- h) **90% or more** of the raw materials, semi-finished goods, and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, or of purchases required for sale, are supplied by the other enterprise, or by a person specified by the other enterprises, and the prices and other conditions relating to the supply are influenced by such other enterprise;
- i) The goods or articles manufactured or processed by one enterprise are sold/transferred to another enterprise or persons specified by the enterprises, and the prices and other conditions relating thereto are influenced by such enterprise or vice-versa;
- j) Where one enterprise is controlled by an individual or jointly by such individual and his relative, and the other enterprise is controlled by such individual or his relative or jointly by such individual and his relative or jointly by a relative of such individual;

- k) Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than 10% interest in such firm, association of persons or body of individuals, or
- l) Where the controlled transaction differs from the transactions that would have been made or imposed by any person not directly participating in the management, control, or capital, as mentioned in Section 76 or 77, but confers a potential advantage to the enterprise.

Permanent Establishment (PE)

A PE is considered to be distinct and a separate entity from its head office and related branches. Thus, any transactions entered between the PE and its head office, as well as related branches, shall be covered under the transfer pricing provisions, and pricing will be determined based on the arm's length principle.

Arm's Length Principle

The arm's length principle has to be derived using any of the five internationally recognized methods, namely, the traditional transaction methods (comparable uncontrolled price, resale price, and cost-plus) and profit split and transactional net margin).

The transfer pricing regulation does not give preference to any specific method or methods, and taxpayers are free to choose the most appropriate method out of the five transfer pricing methods based on the facts and circumstances of each case (in line with the Organisation for Economic Co-operation and Development (OECD) guidelines).

Transfer Pricing Disclosure Forms

According to Regulation 6 of the transfer pricing regulation, the transfer pricing disclosure form is to be prepared and filed annually, along with the Return of Income, by those enterprises that carry out aggregate control transactions that exceed LKR 200 million with AEs during the year of assessment. The following conditions apply:

- Enterprises that carry out categories of transactions that exceed Sri Lankan rupees (LKR) 200 million must complete all fields (Columns I to IV) of the transfer pricing disclosure form.
- Enterprises that carry out aggregate transactions that exceed LKR 200 million, but any category of transaction that does not exceed LKR 200 million for a Year of Assessment must only complete Columns I and II of the transfer pricing documentation form.

In case of domestic transactions, the above threshold is applicable after removing transactions with enterprises that are taxed at the same rates and which do not incur losses for the year and immediately preceding year.

The transfer pricing disclosure form must be filed as per the format disclosed in Annexure IV of the transfer pricing regulation and can be certified by the Director/Principal Officer/Precedent Partner/Proprietor of the enterprise.

Late or inaccurate filing or no filing of transfer pricing documentation form would subject to the penalties specified in Section 184 of the IRA.

The Part B of the transfer pricing documentation form comprises of four columns and allows identification of i) categories of transactions carried out; ii) AEs with whom the transactions have been undertaken iii) the transfer pricing methodology used to test the said transactions; and iv) the comparable arm's length price or range.

Preparing and Maintaining Transfer Pricing Documentation

Enterprises carrying out a controlled transaction with AEs shall be responsible for preparing and maintaining the transfer pricing documentation including:

- **Local File:** referring specifically to material and controlled transactions of the local taxpayer.
- **Master File:** containing standardized information relevant for all the members of a multinational group.
- **Country by Country Report (CbCR):** containing certain information relating to the global allocation of the multinational group's income and taxes paid together with certain indicators of the location of economic activity within the group.

Local File

Part A - Local Entity

A detailed description of the Company that includes ownership structure, management structure, business and business strategy, business restructuring, acquisitions and divestitures, economic and market analyses, forecasts, budgets, and key competitors.

Part B - Controlled Transactions

For each category of the material transaction, provide the following:

- Description of the transaction and amount;
- Identification of AE and relationship;
- Inter-company agreements;
- Comparability and functional analysis of the taxpayer and AE;
- Assumptions, policies, and price negotiations that critically affect the ALP;
- Selection of most appropriate method;
- Selection of tested party;
- Summary of the important assumptions made in applying the transfer pricing methodology;
- List and description of selected comparable uncontrolled transactions (internal or external);
- Description of any comparability adjustments performed; a summary of financial information used in applying the transfer pricing methodology;

- Copy of existing unilateral and bilateral/multilateral APAs and other tax rulings;
- Any other information, data or documents, including information or data relating to the AEs which may be relevant for the determination of the arm's length price.

Part C - Financial information and supporting documents

- Annual local entity financial accounts;
- Information and allocation schedules showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements;
- Summary schedules of relevant financial data for comparables used in the analysis and the sources from which that data was obtained;
- Official publications, reports, studies, and databases from the Government of the country of residence of the AEs, or of any other country which are relevant to the case;
- Reports of market research studies carried out and technical publications, databases brought out by institutions of national or international repute.
- Price publications, including stock exchange and commodity market quotations.
- Letters and other correspondence documenting any terms negotiated between the taxpayer and the AE;

- Documents normally issued in connection with various transactions under the accounting practices followed.

Threshold and Exemptions

Threshold

Preparation of transfer pricing documentation is mandatory in case of transactions with AEs exceeding of LKR 200 million (approximately USD 1.08 million).

Taxpayers (meeting the above thresholds) are required to keep contemporaneous documentation in English for demonstrating the arm's length nature of the related party transactions.

The record-keeping (i.e., retention of the documentation) should be made for a period of six years from the end of the relevant year of assessment.

The threshold applies to the aggregated value of the transactions with an AE.

Exemptions

For cases where the aggregate value of intragroup transactions does not exceed the above identified limits, there is no requirement to prepare transfer pricing documentation. However, the taxpayer, in such cases, is required to substantiate the arm's length nature of related party transactions.

Where any controlled transaction continues to have an effect over more than one year of assessment, fresh documentation need not be maintained separately in respect of each year of assessment, unless there is any significant change in the nature or terms of such transaction, in the assumptions made, or in any other

factor which could influence the transfer price, and in case of such significant change, fresh documentation as may be necessary under this Regulation shall be maintained bringing out the impact of change on the pricing of such transaction.

In case the taxpayer's operation reflects no significant change, the searches in databases for comparables should be updated every three years instead of annually.

Master File

The MF is to be prepared and maintained by those enterprises that have declared revenue whose value exceeds LKR 7.5 billion (USD 406.60 million) for each year of assessment, as recorded in the books of account.

The following information shall be included in the MF:

- Part A - Organizational structure
- Part B - Description of MNE's business(es)
- Part C - MNE's intangibles
- Part D - MNE's intercompany financial activities
- Part E - MNE's financial and tax positions

CbCR

CbCR regulations shall be effective for Reporting Fiscal Years of MNE Groups beginning on or after 1 April 2019. The CbCR shall be filed by each Ultimate Parent Entity of the MNE Group that is resident for tax purposes in Sri Lanka or a Constituent Entity, which is not the Ultimate Parent Entity of an MNE Group having

a group total consolidated group revenue of greater than 115 billion LKR. Regulations under section 194 of the IRA, No. 24 of 2017, has provided a definition of important terms for the submission of CbCR.

The CbCR shall be filed no later than 12 months after the last day of the Reporting Fiscal Year of the MNE Group.

Selection of Comparable Data

For comparability analysis, the taxpayer can use publicly available databases. Based on our experience, due to an absence of the local databases, the Inland Revenue Department (IRD) has opted to use Indian or any other appropriate database, while appropriate adjustments need to be made if necessary, to arrive at arm's length price.

Submission of Transfer Pricing Documentation

Taxpayers are not required to submit documentation along with the return of income. However, it needs to be submitted to tax authorities within 30 days upon request.

Transfer Pricing Audit/Assessment

The IRD established a Transfer Pricing Regulations Unit (TPRU) for the implementation and administration of the transfer pricing regulation and provided a framework to confirm if related party transactions comply with the arm's length principle.

In case where the Transfer Pricing Officer has been assigned to determine the arm's length price of the international transaction, he/she shall prepare a preliminary order and refer it to the Technical Review Committee, which is appointed by the Deputy Commissioner-General.

The Technical Review Committee shall issue:

- a) Final order, if all the members of the Committee are in agreement; or
- b) An interim order in any other circumstances where all the members of the Committee are not in agreement

In case the assessee is aggrieved by the interim order, the assessee can make reference to the Dispute Resolution Panel, who shall issue a final order. The assessee can, within 30 days of the notice of the assessment, make an appeal to the Commissioner-General.

Advance Pricing Agreements (APA) Procedures

IRD has made arrangements for entering into an APA in accordance with an appropriate set of criteria (e.g., method, appropriate adjustments thereto, and critical assumption as to the future events) for controlled transactions for the determination of the transfer pricing for those transactions over a fixed period of time.

The options available are Unilateral APA and Bilateral APA. The APA provisions related to eligibility of application, term limits, application procedure and process, annual compliance procedures, fees, and other related procedures **are yet to be notified.**

Penalties and Other Consequences of Non-compliance

Any tax adjustment made on account of transfer pricing will not be entitled to tax benefits. The following penalties are introduced for both domestic and international transactions as per section 184 of the IRA:

Apart from the penalties mentioned in section 184, the penalties specified in section 185 and criminal proceedings specified in Chapter XVIII are applicable for transfer pricing.

Penalty under section 185

A person who fails to comply with a request for information properly made under this Act, within the specified time, shall be liable for a penalty of an amount not exceeding one million rupees.

Violation	Penalty
Non-disclosure of any required information	2% of the total value of transactions between related parties
Non-maintenance of required documents	1% of the total value of transactions with AEs
Non-submission of required documents	Up to INR 250,000
Non-submission of required documents on time	Up to INR 100,000
Concealment of particulars of income or furnishing of inaccurate particulars of such income and seeking to evade tax through the same	200% of the value of the additional tax on such income

BEPS/CbC Applicability

Base Erosion and Profit Shifting (BEPS) issues and CbCR are expected to be more remote. For the time being, transfer pricing regulations in the country still need to mature.

Summary of Transfer Pricing Requirements

Compliance Requirements

1. Transfer Pricing Disclosure Form

The transfer pricing disclosure form is to be prepared and filed annually, along with the Return of Income by Enterprises that carry out transactions with AEs.

On fulfillment of certain conditions, the details on i) Transaction, ii) AE, iii) Transfer pricing methodology, and iv) Arm's length price are required to be provided.

The transfer pricing disclosure form is to be filed as per the format disclosed in Annexure IV of the transfer pricing regulations and needs to be certified by the Director/Principal Officer/Precedent Partner/Proprietor of the enterprise.

2. Transfer Pricing Documentation

Transfer pricing documentation is mandatory for an enterprise having transactions with its AEs exceeding LKR 200 million (approximately USD 1.08 million).

Penalties

Specific penalties have been introduced for TP non-compliance.

Method and Preference for Comparable

Five methods as defined by OECD without any hierarchy.

Safe Harbour and APA

Safe Harbour Rules are to be introduced for simplifying the transfer pricing compliance requirements.

APA provisions related to eligibility of application, term limits, application procedure and process, annual compliance procedures, fees, and other related procedures to be notified.

BEPS and CbCR Applicability

1 April 2018

About Nexdigm (SKP)

Nexdigm (SKP) is a multidisciplinary group that helps global organizations meet the needs of a dynamic business environment. Our focus on problem-solving, supported by our multifunctional expertise enables us to provide customized solutions for our clients.

Our cross-functional teams serve a wide range of industries, with a specific focus on healthcare, food processing, and banking and financial services. Over the last decade, we have built and leveraged capabilities across key global markets to provide transnational support to numerous clients.

We provide an array of solutions encompassing Consulting, Business Services, and Professional Services. Our solutions help businesses navigate challenges across all stages of their life-cycle. Through our direct operations in USA, India, and UAE, we serve a diverse range of clients, spanning multinationals, listed companies, privately owned companies, and family-owned businesses from over 50 countries.

Our team provides you with solutions for tomorrow; we help you *Think Next*.

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