

# Transfer Pricing

## Chartered Accountancy Strategic Level Corporate Taxation (TAX)

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## 10. TRANSFER PRICING

### 1. Transfer Pricing

With the advent of global trade, cross border transactions have become very common. Consequently, there is a general tendency for multinational corporations to reconstruct/split operations between different group companies to obtain a tax advantage globally. Prices between related parties are usually not based on market forces, so the prices may be set in a manner where a particular good or service is overcharged/ undercharged to maximise the group profits.

Transfer pricing rules govern transactions between associated. Accordingly, any income, gains and profits arising in, derived or accrued from, or loss incurred in any international transaction or any transaction other than an international transaction between two associated enterprises are determined by giving regard to the Arm's length price.

All business organisations which have permanent establishments in Sri Lanka shall be deemed to be a person resident in Sri Lanka for the purpose of ascertainment of income, gain or profits arising in or derived from any loss incurred in Sri Lanka from such permanent establishment. In a situation where, a transaction takes place between a permanent establishment and its head office or other related branches in Sri Lanka, the permanent establishment shall be treated as a distinct and separate entity from its head office and related branches. Therefore, such transactions are also required to be concluded at Arm's Length Price.

### 2. Transactions

In terms of Section 76, an international transaction is defined as a transaction between two or more associated enterprises, either one or both of whom are non-residents, engaged in one or more of the following;

- (a) Purchases, sale or lease of tangible or intangible property
- (b) Provision of services
- (c) Lending or borrowing of money
- (d) Any other transaction having a bearing on the income, gain or profits, losses or assets of such associated enterprises, and
- (e) Any allocation or apportionment of, or any contribution to any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such associated enterprises under any mutual agreement or arrangement between two or more such associated enterprises.

Further, the Act deems transactions between an enterprise and an unassociated person to be deemed as an international transaction within the purview of transfer pricing, if there is a prior agreement and the terms of the transaction could potentially give rise to a reduction in tax payable.

Any transaction other than an international transaction (i.e. domestic transactions) are covered under section 77.

### **3. Associated Enterprises**

The law defines a person to be an Associated Enterprise of another, if one person participates directly or indirectly or through one or more intermediaries in the management, control or capital of the other person or if any of the criteria which are set out by Gazette Extraordinary No. 2217/7 dated 02<sup>nd</sup> March 2021 are met.

### **4. Arm's length price**

The "Arm's length Price" means for the purposes of ascertaining income, gain or profits arising in, derived or accruing from or losses incurred in any transaction, operation or scheme entered into between two associated enterprises, calculated in accordance with the arm's length principle, as that where a connected transaction is carried out taking into account the terms and conditions that would have been used in comparable independent transactions.

In essence, therefore the Arm's length price should be the price which would have been agreed upon between independent parties engaged in the same or similar transactions. Application of arm's length principle treats associated enterprises as distinct separate entities rather than inseparable parts of a single unified business. The regulations stipulate various pricing methodologies that maybe applied to determine Arm's length price and the most appropriate method must be chosen and justified for the transaction in hand.

### **5. Transfer Pricing methods**

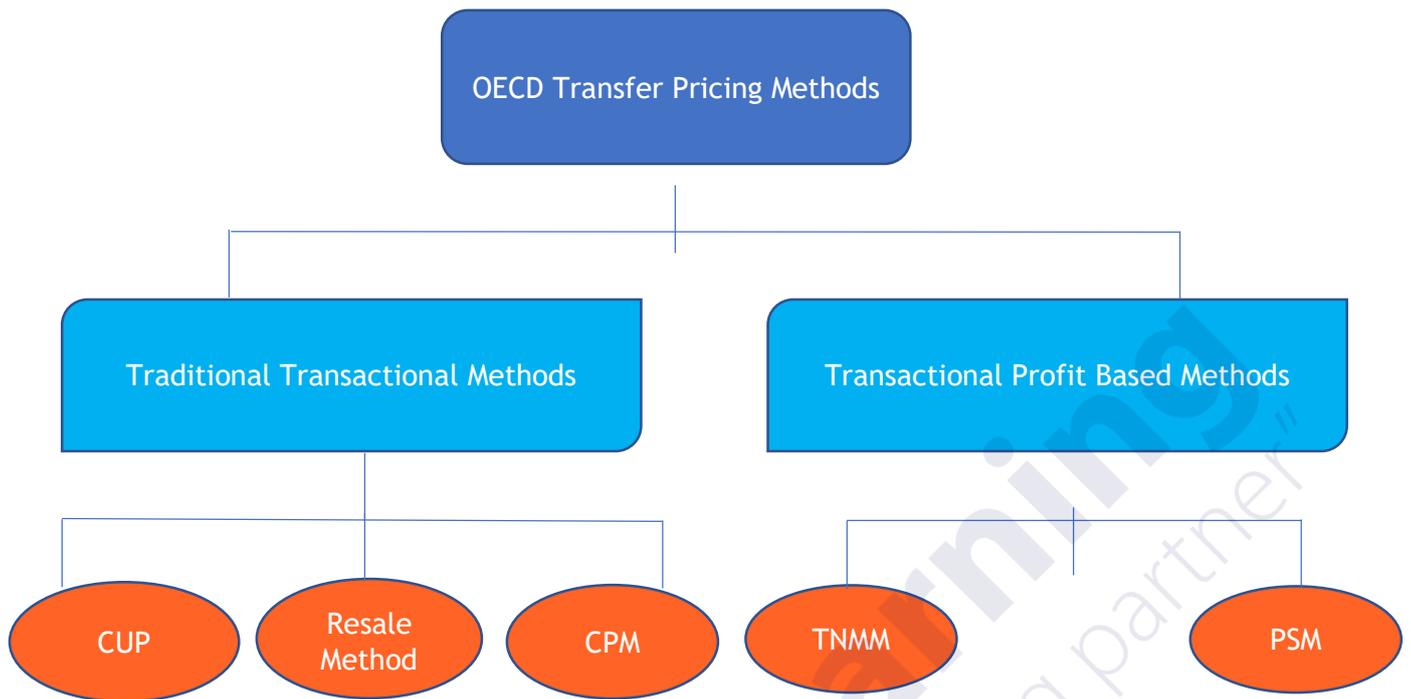
The transaction between two associated enterprises shall be within an arm's length price, according to the Section 76 and Section 77 of the Act. The arm's length price shall be determined by the application of the most appropriate method to the facts and circumstances of the case from any of the methods outlined below as mentioned, in the OECD Guidelines.

#### **Traditional transaction methods:**

1. CUP method
2. Resale price method
3. Cost plus method

#### **Transactional profit methods:**

4. Transactional net margin method (TNMM)
5. Profit split method.



The following are the method prescribed under the regulations;

Prescribed method	Methods of comparison
Comparable uncontrolled Price method (CUP)	Comparison with price of similar transactions with third parties or comparison with external market prices
Cost plus method (CPM))	Comparison of the gross profitability of the transaction with profitability of a similar transaction with third parties or with external data relating to profitability.
Resale price method (RPM)	
Transactional net margin method (TNMM)	Comparison of the operating profitability of the business operations with related party with similar business operations with third parties or with operating profitability of entity engaged in similar operations.
Profit split method (PSM)	Allocation of group profits based on value of contribution by respective entities to the Group revenue.

### COMPARABLE UNCONTROLLED PRICE METHOD (CUP)

The method compares the price charged for property or services transferred in a controlled transaction with the price charged for property or services in a comparable

transaction undertaken between independent parties. To be considered a CUP, an uncontrolled transaction has to meet high standards of comparability.

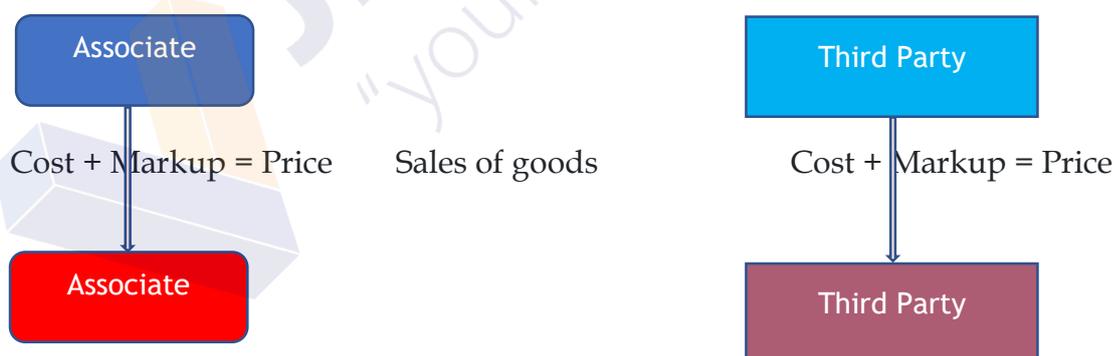


### RESALE PRICE METHOD (RPM)

The Resale Price Method (RPM) is based on the gross margin or difference between the price at which a product is purchased and the price at which it is on-sold to a third party. The resale price less the arm's-length gross margin is considered to be the arm's-length transfer price for the goods. this method is typically most appropriate to distributors and resellers.

### COST PLUS METHOD (CPM)

The Cost Plus method seeks to determine an arm's-length range of prices for a transaction by identifying the costs incurred by the vendor of the goods or services in a controlled transaction and then adding an arm's-length mark-up to that cost base. The mark-up should be comparable to what a third party would earn if it performed comparable functions, bore comparable risks, owned the same assets and operated in comparable market conditions.



### TRANSACTIONAL NET MARGIN METHOD (TNMM)

The TNMM tests the net profit margin earned in a controlled transaction with the net profit margin earned by the related party on the same transaction with a third party or the net margin earned by a third party on a comparable transaction with another third party.

The net profit margin can be measured against a number of bases including sales, costs or assets, and in practice is typically applied by targeting an operating margin within a set range.

### **PROFIT SPLIT METHOD (PSM)**

The Profit Split Method (PSM) seeks to determine the way that a profit arising from a particular transactions would have been split between the independent businesses that were party to the transaction. The PSM divides the profit based upon the relative contribution of each related party business to the transactions enterprise as determined by their functional profile and, where possible, external market data.

<b>Associate Parties</b>	<b>A</b>	<b>B</b>	<b>C</b>	<b>Total</b>
Profit	5	10	15	30
Independent businesses (Bench Mark)	8	6	10	24
Profit Under PSM	10	7.5	12.5	

A comparability analyses of uncontrolled data to be performed, to ascertain the arm's length price/profit margin for transactions under review.

For comparison purposes, data relating to the current financial year of uncontrolled transactions to be considered. The data of the previous 2 years could be used only if previous data reveals facts which have an influence on the determination of price for transactions under review.

If more than one price/profit margin is determined through the comparability analysis, the arm's length nature of the transaction to be determined as follows;

- Arm's length range to be ascertained considering the 40<sup>th</sup> and 60<sup>th</sup> percentile of uncontrolled prices/profit margins.
- If actual price falls within arm's length range, transaction considered to be at arm's length.
- If not, price adjustment to be done, considering median (50<sup>th</sup> percentile) as the arm's length price.

## **6. Transfer Pricing in relation to International Transactions (Sec. 76)**

### **6.1. Income, Gain and Profit or Loss between Associated Enterprises shall be ascertained having regard to the Arm's Length Price (Sec. 76(1))**

Any income, gains and profits arising in or any loss incurred by any person in Sri Lanka engaged in any international transaction entered into with its associated enterprises shall be ascertained having regard to the arm's length price.

### **6.2. Status of Permanent Establishment**

Permanent establishment in Sri Lanka shall be deemed to be a person (Sec. 76(2)(a)) Any business organization that has a permanent establishment in Sri Lanka shall be deemed to be a person for the ascertainment of the income, gains or profits arising in or any loss incurred in Sri Lanka from such permanent establishment;

**6.2.1. Permanent establishment shall be treated as distinct and separate entity from head office (Sec. 76(2)(c))**

Any income, gains or profits arising or any loss incurred in any transaction between a permanent establishment and its head office or other related branches in Sri Lanka, in which case the permanent establishment shall be treated as a distinct and separate entity from its head office and related branches, shall be ascertained having regard to the arm's length price;

**6.3. Meaning for "permanent establishment"**

**6.3.1. The country with which Sri Lanka has DTA (Sec. 76(2)(b)(i))**

"Permanent establishment" in relation to a country with which an agreement has been entered into on avoidance of double taxation means, a permanent establishment defined in an agreement for the relief of double taxation where an agreement is in force between the government of Sri Lanka and the government of any territory in which any person and their agencies, branches or establishments in Sri Lanka is resident.

**6.3.2. The country with which Sri Lanka has no DTA (Sec. 76(2)(b)(ii))**

"Permanent establishment" in relation to a country with which an agreement has not been entered into on avoidance of double taxation, includes any business connection or a fixed place of business through which the business of the enterprise is wholly or partly carried out irrespective of the number of days of such business carried out in Sri Lanka;

**6.4. Definition for "international transaction" (Sec. 76(2)(d))**

"international transaction" means a transaction between two or more associated enterprises, either one or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, lending or borrowing of money or any other transaction having a bearing on the income, gain or profits, losses or assets of such associated enterprises, and includes any allocation or apportionment of, or any contribution to any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such associated enterprises under any mutual agreement or arrangement between two or more such associated enterprises.

Any transaction entered into by an enterprise with a person, other than an associated enterprise shall be deemed to be an international transaction

entered into between two associated enterprises, if there exists a prior agreement between such enterprises and other person and, by which the terms of such transaction are determined in substance between such enterprises and other person which results in the reduction of or would have the effect of reducing the amount of tax payable.

Without prejudice to the generality of the provision of this subsection, the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price.

## **6.5. Transfer Pricing Audit**

### **6.5.1. Initiating Transfer Pricing Audit (Sec. 76(3)(a) and (b))**

Where it appears to the Transfer Pricing Officer that the income, gain or profits or the loss have not been ascertained having regard to the arm's length price, he may initiate a transfer pricing audit.

Where it appears to an Assistant Commissioner in the course of his audit that the income, gain, profits or the loss have not been ascertained having regard to the arm's length price he shall refer to the Transfer Pricing Officer for the determination of arm's length price and if the Transfer Pricing Officer decides to proceed with a transfer pricing audit he shall initiate such transfer pricing audit.

Section 77(5) defines the phrase "transfer pricing officer" as follows.

*"Transfer Pricing Officer" means any officer of the Inland Revenue Department designated by the Commissioner-General as a Transfer Pricing Officer;*

### **6.5.2. Determining Arm's Length Price (Sec. 76 (3)(c))**

When determining the arm's length price, the Transfer Pricing Officer may in writing addressed to the person require him to prove to the satisfaction of the Transfer Pricing Officer, that such income, gain or profits or such loss, has in fact been ascertained having regard to the arm's length price.

Where such person fails to so prove, the Transfer Pricing Officer may determine, the arm's length price.

### **6.5.3. Appropriate Method of Transfer Pricing (Sec. 76 (3)(e))**

The arm's length price shall be determined in accordance with the arm's length principle and on the basis of the application of the most appropriate method as specified for that purpose.

### **6.5.4. Referring to the Technical Review Committee (Sec. 76 (3)(f))**

After determining arm's length price of the cases initiated, Transfer Pricing Officer shall prepare a preliminary order determining the arm's length price and refer to the Technical Review Committee which is appointed by the Deputy Commissioner General of the subject of transfer pricing, for review.

**6.5.5. Final Order or Interim Order of Technical Review Committee (Sec. 76 (3)(g))**

The Technical Review Committee shall review the determined arm's length price in the preliminary order and **shall confirm, reduce or enhance the arm's length price** and refer to the Transfer Pricing Officer –

- i) a final order, if all the members of the Committee are in agreement; or
- ii) an interim order in any other circumstances where all the members of the Committee are not in agreement.

**6.5.6. Communication of Final Order or Interim Order to the Taxpayer (Sec. 76 (3)(h))**

Transfer Pricing Officer shall communicate the final order or the interim order as the case may be to such person.

**6.5.7. Communication of the Dissatisfaction to the Dispute Resolution Panel (Sec. 76 (3)(i) and (j))**

A person, who is dissatisfied with the interim order may communicate his dissatisfaction to the Dispute Resolution Panel referred to in section 78 of this Act and the Dispute Resolution Panel shall issue a final order under subsection (4) of section 78.

Where person or partner of a partnership has not communicated their dissatisfaction on an interim order received to the Dispute Resolution Panel, the interim order shall be deemed to be a final order.

**6.5.8. Assessment by Transfer Pricing Officer (Sec. 76 (3)(k))**

The Transfer Pricing Officer shall, subject to the provisions of section 135, assess the amount of income, gain or profits and issue assessment in accordance with the final order of the Technical Review Committee or the Dispute Resolution Panel as the case may be.

**6.5.9. Appealing against the Assessment (Sec. 76(3)(l))**

Such person or partner of a partnership, who is aggrieved by such assessment made based on the final order, may within thirty days of the notice of assessment make an appeal to the Commissioner General under Chapter XIII.

**6.6. No Exemption or any Other Tax Benefit (Sec. 76(5))**

Notwithstanding anything to the contrary in any other section of this Act or any other law, no exemption or tax benefit provided under any of the provisions of this Act or any other law, shall be granted in respect of the amount of income, gain or profits by which the total income, gain or profits of the associated enterprises is increased after the computation of income, gain or profits under this section and in accordance with the arm's length price.

## **6.7. Advance Pricing Agreement (Sec. 76(6))**

An advance pricing agreement may be entered into between any person and the Commissioner General in respect of arm's length price for the purposes of this section in the manner that may be specified.

## **6.8. Safe Harbor Rules (Sec. 76(7))**

The determination of arm's length price may be subject to safe harbor rules specified by the Commissioner General.

Section 77(5) defines the phrase "safe harbor" as follows.

*"safe harbor" means circumstances in which the Commissioner General may propose a simplification measure that shall accept the transfer price declared by a person under certain conditions;*

## **7. Transfer Pricing in relation to domestic transactions (sec. 77)**

### **7.1. Income, Gain and Profit or Loss between Associated Enterprises shall be ascertained having regard to the Arm's Length Price (Sec. 77(1))**

Any income, gain or profits arising in or any loss incurred in by any person in Sri Lanka engaged in any transaction (other than transactions referred to in subsection (1) of section 76 ) entered into with its associated enterprises shall be ascertained having regard to the arm's length price.

### **7.2. Transfer Pricing Audit (Sec. 77(2))**

#### **7.2.1. Initiating Transfer Pricing Audit (Sec. 77(2)(a))**

Where it appears to the Assistant Commissioner in the course of his audit, the income, gains or profits or the loss have not been ascertained having regard to the arm's length price, he may initiate a transfer pricing audit.

#### **7.2.2. Determining Arm's Length Price (Sec. 77(2)(b))**

When determining the arm's length price the Assistant Commissioner may in writing address to the person and require him to prove to the satisfaction of the Assistant Commissioner, that such profits and income or such loss has in fact been ascertained having regard to the arm's length price.

Where such person fails to so prove, the Assistant Commissioner may determine, the arm's length price.

#### **7.2.3. Method of Transfer Pricing (Sec. 77(2)(d))**

The arm's length price shall be determined in accordance with the arm's length principle and on the basis of application of the most appropriate method, as specified for that purpose.

#### **7.2.4. Referring to the Technical Review Committee (Sec. 77(2)(e))**

After determining arm's length price, the Assistant Commissioner shall prepare a preliminary order and refer to the Technical Review Committee, for review.

#### **7.2.5. Final Order or Interim Order of Technical Review Committee (Sec. 77(2)(f))**

The Technical Review Committee shall review the determined arm's length price in the preliminary order and shall confirm, reduce or enhance the arm's length price and refer to the Assistant Commissioner -

- i) a final order, where all the members of the Committee are in agreement; or
- ii) a interim order in any other circumstances where all the members of the Committee are not in agreement.

#### **7.2.6. Communication of Final Order or Interim Order to the Taxpayer (Sec. 77(2)(g))**

Assistant Commissioner shall communicate the final order or the interim order as the case may be to such person or partner of such partnership.

#### **7.2.7. Communication of Dissatisfaction to the Dispute Resolution Panel (Sec. 77(2)(h))**

A person, who is dissatisfied with the interim order may communicate his dissatisfaction to the Dispute Resolution Panel and the Dispute Resolution Panel shall issue a final order under subsection (4) of section 78.

Where a person has not communicated his dissatisfaction on an interim order, the interim order is deemed to be a final order.

#### **7.2.8. Assessment by Assistant Commissioner (Sec. 77(2)(j))**

The Assistant Commissioner shall subject to the provisions of section 135 assess the amount of income, gain or profits and issue assessment in accordance with the final order of the Technical Review Committee or the Dispute Resolution Panel.

#### **7.2.9. Appealing against the Assessment (Sec. 77(2)(k))**

If such a person who is aggrieved by such assessment made based on the final order, may, within thirty days of the notice of assessment make an appeal to the Commissioner General.

### 7.3. No Exemption or any other Tax Benefit (Sec. 77(4))

Notwithstanding anything in any other section of this Act or any written law, no exemption or tax benefit provided under any of the provisions of this Act or any written law, shall be granted in respect of the amount of income, gain or profits by which the total income, gain or profits of the associated enterprises is increased after the computation of income, gain or profits under this section and in accordance with the arm's length price.

## 8. REGULATIONS ISSUED ON TRANSFER PRICING

### 8.1. Introduction of the Gazette No. 2104/4 dated December 31, 2018 (effective from April 01, 2018)

According to the Transfer Pricing Regulation issued by the Minister of Finance and Mass Media, any income, gains and profits arising in, derived or accruing from, or any loss incurred by any person in Sri Lanka engaged in any "international transaction" or "domestic transaction" entered into with its associated enterprises shall be ascertained having regard to the arm's length price.

### 8.2. Applicability of the Regulation to Domestic Transactions (Clause 01)

In the case of domestic transactions, Transfer Pricing Regulation apply only to the following domestic transactions.

- (a) If there are **tax exemptions granted to any one of the associated enterprises** under the Inland Revenue Act, No. 38 of 2000 or Inland Revenue Act, No. 10 of 2006 or No. 24 of 2017 or under the Board of Investment of Sri Lanka Law No. 4 of 1978 ; or
- (b) If any **difference between income tax rates specified** in any of the Schedules to the Inland Revenue Act or any income tax rate given in the agreement entered into under the Board of Investment of Sri Lanka Law No. 4 of 1978 is applicable **to any one of the associated enterprises** ; or
- (c) If any **loss incurred by any of the associated enterprises** for the year of assessment or immediately preceding years of assessment which has been brought forward to that year of assessment.

### 8.3. A person and an Associated Enterprise (Sec. 77(5)(a))

**"a person" -**

- i. shall be an associated enterprise of another enterprise, if one person participates directly or indirectly or through one or more intermediaries in the management, control or capital of the other person; (a person

- referred to in this paragraph shall include a permanent establishment);  
or
- ii. shall be deemed to be an associated enterprise of another person if one person participates directly or indirectly or through one or more intermediaries in the management, control or capital, in such manner or to such extent as may be specified;

### **Clause 8 of the Gazette**

For the purposes of Section 76 and 77 of the Act, and for these Regulations, two enterprises shall be deemed to be associated enterprises, if, at any time during the year of assessment, any of the following conditions is met.

- 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 fifty percent of the voting power in each of such enterprise ;
- c) loans advanced by one enterprise to another enterprise constitute not less than fifty-one percent of the book value of the total assets of the other enterprise provided that it is not given by a bank which is not considered as an associated enterprise under any other item of this Regulation ;
- d) loans and equity provided by one enterprise to another enterprise constitute not less than fifty-one per cent of the book value of the total assets of the other enterprise provided that it is not given by a bank which is not considered as an associated enterprise under any other item of this Regulation;
- e) one enterprise guarantee not less than twenty-five percent 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 of members of the governing board, of each of the two enterprises are appointed by the same person or persons ;
- h) ninety per cent 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 the sale, are supplied by the other enterprise, or by 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 to 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 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 ten per cent 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.

#### **8.4. Arm's Length Price (Sec 77(5)(c))**

"Arm's Length Price" means for the purpose of ascertaining income, gain or profits arising in, derived or accruing from or losses incurred in any transaction, operation or scheme entered into between two associated enterprises calculated in accordance with the arm's length principle, as that where a connected transaction is carried out taking into account the terms and conditions that would have been used in comparable independent transactions.

#### **Clauses 2, 3, 4 and 5 of the Gazette**

According to the regulations, the arm's length price shall be determined by the application of the most appropriate method to the facts and circumstances of the case from any of the methods outlined below:

- (a) Comparable Uncontrolled Price Method
- (b) Resale Price Method
- (c) Cost Plus Method
- (d) Transactional Net Margin Method
- (e) Profit Split Method

The most appropriate method shall be the method which is best suited to the facts and circumstances of each particular controlled transaction between associated enterprises, and which provides the most reliable measure of an arm's length price in relation to such transaction.

#### **8.5. Transfer Pricing Documentation and Disclosure Form (Clause 6 of the Gazette)**

Enterprises carrying out controlled transactions with associated enterprises subject to Section 76 and 77, as the case may be, must maintain documents and submit information regarding controlled transactions, including information on those associated enterprises, as follows.

For Multinational Groups, three-tier documentation (Master File, Local File and Country by Country report) requirements in line with Action 13 of Base Erosion and Profit Shifting (BEPS) initiative of the Organisation for Economic Cooperation and Development (OECD), has been introduced.

“Multinational Group” is defined to mean a group of entities with two or more enterprises which are tax residents of different jurisdictions or carrying out business in another jurisdiction via a permanent establishment.

Local entities would be required to maintain a local file.

Type of document	What it is	Who is required to maintain
Master File	Contains standardized information relevant for all the members of a multinational group.	A local taxpayer being a member of a multinational group, if declared group revenue whose value exceeds 50 million Euro or its equivalent in Sri Lanka Rupees for each year of assessment.
Local File	Contains prescribed information related to material transactions (i.e. international and domestic) of local taxpayers and the basis of justification of pricing for such transaction.	Local taxpayers with categories of controlled transactions with Associated Enterprises which exceeds LKR 200 million for each year of assessment

**(i) Local File referring specifically to material and controlled transactions of the local taxpayer, according to Annexure I ;**

The Local File is to be prepared and maintained by those enterprises that carry out controlled transactions or each category of controlled transactions with associated enterprises exceed Sri Lankan Rupees (LKR) 200 million for each year of assessment as recorded in the books of account. The local file must be prepared in English in the case of international transactions. The Local file should be kept available for a period of six years from the end of the relevant year of assessment, and it should include the information specified in Annexure I of the Regulation (The transaction here does not include dividend and granting or repayment of loan capital)

**(ii) Master File containing standardized information relevant for all the members of a multinational group, according to Annexure II ;**

The Master File is to be prepared and maintained by those enterprises that have declared revenue whose value exceeds LKR 7.5 billion for each year of assessment as recorded in the books of account. The Master file which is maintained in English should include the information specified in Annexure II of the Regulation.

**(iii) 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, according to Annexure III.**

The CbCR shall be filed by the Ultimate Parent Entity or a Constituent Entity of a MNE group. For this purpose, MNE group means any Group that includes two or more enterprises the tax residence for which is in different jurisdiction, or includes an enterprise that is resident for tax purposes in one jurisdiction and is subject to tax with respect to the business carried out through a permanent establishment in another jurisdiction, and having total consolidated group revenue of more than Rs. 115 billion during the Fiscal Year immediately preceding the Reporting Fiscal Year.

The regulations in respect to the CbCR shall be effective for the reporting fiscal years beginning on or after April 1, 2019 and CbCR shall be filed not later than 12 months after the last day of the Reporting Fiscal Year of the MNE Group.

Further, any Constituent Entity of an MNE Group that is resident for tax purposes in Sri Lanka shall notify the Commissioner General of Inland Revenue Department whether it is or it is not the Ultimate Parent Entity or the Surrogate Parent Entity, not later than December 31<sup>st</sup> of the Reporting Fiscal Year of such MNE Group.

In summary, there are two reporting requirements;

1. Submit the notification to the Commissioner General of Inland Revenue Department before 31<sup>st</sup> December of each accounting period whether the constituent entity is the Ultimate Parent Entity or the Surrogate Parent Entity
2. Submit the Country-by-Country Report within 12 months from the last day of the Ultimate Parent Entity's accounting period if the regulation applies

#### **8.6. Preparation and Submission of Transfer Pricing Disclosure Form**

Enterprises that carry out controlled transactions or categories of controlled transactions with associated enterprises are obliged to prepare and file an annual transfer pricing disclosure form along with the Return of Income as per the format and under the conditions disclosed in **Annexure IV**.

Copy of the relevant gazette notification is attached herewith. You may refer to the attached gazette notification for the definition of terms used in the regulation.

#### **9. Transfer Pricing compliance requirements**

The regulations set out by the Gazette Extraordinary No. 2104/4 dated 31<sup>st</sup> December 2018 provides the Transfer Pricing compliance requirements which includes maintenance of documentation and filing obligations.

These requirements apply to all international transactions and specified domestic transactions between Associated Enterprises (AEs) where;

- One of the AEs is exempt from tax
- The tax rate applicable to AEs are different

- Incurred in current year or brought forward tax losses (tax loss incurred in current year or brought forward tax losses)

## 10. Impact of Transfer Pricing adjustment

The provisions of section 76 and 77 would apply if the computation of income under these provisions would result in,

- Reduction of income, gain or profit chargeable to tax, or
- Increase of loss

Further, tax exemptions or tax benefits provided under any of the provisions of the IRA or any other law shall not be applicable in respect of the amount of income, gain or profits of the associated enterprises that are computed in accordance to the Arm's length price.

If the Tax Authority of another jurisdiction performs adjustments to the transfer price in relation to an international transaction, by increasing the income or profits in that other jurisdiction, the corresponding adjustment to the expenses, will be allowed to the entity in Sri Lanka only if a Double Tax Treaty Agreement prevails with the other jurisdiction, upon review of such adjustment by the CGIR.

Corresponding adjustment is not allowed for domestic transactions.

## 11. Penalties

Required documents not maintained - 1% of aggregate value of transaction.  
 Required document not furnished - Penalty of Rs. 250,000.00  
 Non-disclosure of required information - 2% of aggregate value  
 Documents have not been submitted on specified date - Rs. 100,000.00  
 Concealed the particulars of his income - 200% of the value of additional tax  
 Furnishing inaccurate particulars of income - 200% of the value of additional tax

## 12. Provisions to minimize tax avoidance

### 12.1. Arm's Length Standard and Arrangement between Associates (Sec. 33)

Where an arrangement exists between associated persons, the persons shall calculate their income and tax payable according to the arm's length standard.

The phrase "arrangement" is defined under section 195 as follows.

*"arrangement" means -*

- an action, agreement, course of conduct, dealing, promise, transaction, understanding or undertaking, whether express or implied, whether or not enforceable by legal proceedings and whether unilateral or involving more than one person; or*
- a part of an item described in paragraph (a);*

For this purpose, the phrase "associated persons" is defined under section 196.

The arm's length standard requires associated persons to quantify, characterise, apportion and allocate amounts to be included or deducted in calculating income to reflect arrangements that would have been made between independent persons.

The Commissioner General may by publication in the *Gazette* specify the manner in which arm's length agreements may be entered into for the purpose of determining the arm's length price.

Where, in the opinion of the Commissioner General, a person fails to comply with the above, the Commissioner General may make adjustments in compliance with above provision and the Commissioner General may -

- a) **re-characterise an arrangement** made between associated persons, including re-characterising debt financing as equity financing;
- b) **re-characterise the source** and type of any income, loss, amount or payment; and
- c) **apportion and allocate expenditure**, based on turnover.

#### 12.2. Income Splitting (Sec. 34)

Where a person attempts to split income with another person, the Commissioner General may prevent any reduction in tax payable by issuing a notice in writing.

The said notice may contain amounts to be included or deducted in calculating the income of each person or re-characterise the source and type of any income, loss, amount or payment.

A reference to a person attempting to split income includes a reference to an arrangement between associated persons -

- a) for the transfer of an asset (directly or indirectly), including the transfer of an amount to be derived;
- b) where the transferor retains any legal or implicit right to benefit (currently or in the future) from the asset; and
- c) where one of the reasons for the transfer is to lower tax payable by any person.

Where a spouse receives income for services rendered in any business carried on or exercised -

- (a) 4. by the other spouse; or
- (b) by a partnership of which that other spouse is a partner,

the income shall be included in the income of the spouse who carries on the business or that partnership of which that other spouse is a partner.

### **12.3. Tax Avoidance Scheme (Sec. 35)**

#### **12.3.1. Application of this section (Sec. 35(1))**

This section shall apply where the Commissioner General is satisfied that –

- a) a scheme has been entered into or carried out;
- b) a person has obtained a tax benefit in connection with the scheme; and
- c) having regard to the substance of the scheme, it can be concluded that a person, or one of the persons, who entered into or carried out the scheme did so for the sole or dominant purpose of enabling the person referred to in paragraph (b) to obtain a tax benefit.

#### **12.3.2. Definitions for “Scheme” and “Tax Benefit” (Sec. 35(5))**

*“scheme” includes any course of action, trust, grant, agreement, arrangement, understanding, promise, plan, proposal or undertaking, whether express or implied and whether or not enforceable;*

*“tax benefit” means –*

- a) a reduction in a liability to pay tax, including on account of a deduction, credit, offset or rebate;
- b) a postponement of a liability to pay tax;
- c) any other advantage arising because of a delay in payment of tax; or
- d) anything that causes –
  - i) an amount of gross revenue to be exempt income or otherwise not subject to tax; or
  - ii) an amount that would otherwise be subject to tax not to be taxed.

#### **12.3.3. Determination of tax liability by Commissioner General of a person who obtained the tax benefit (Sec. 35(2))**

Notwithstanding anything in this Act, the Commissioner General may determine the tax liability of the person who obtained the tax benefit as if the scheme had not been entered into or carried out, or as if a reasonable alternative to entering into or carrying out the scheme would have instead been entered into or carried out, or that any transaction which reduces or would have the effect of reducing the amount of tax payable by any person is artificial or fictitious and can make compensating adjustments to the tax liability of any other person affected by the scheme.

Where a determination or adjustment is made, the Commissioner General shall issue an assessment giving effect to the determination or adjustment.

The assessment made shall be served within five years from the last day of the year of assessment to which the determination or adjustment relates.