

# **Strategic Level – CA Sri Lanka**

Strategic Tax Planning (SL - 25 - 4) –Tutorial 11

## **TRANSFER PRICING REGULATION [TP]**

Prabath Weerasinghe – ACA, MAAT, BB Mgt (HRM) SP, ACMA,  
ATII, MBA in Taxation (PIM SJP )

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# Transfer Pricing Regulations

## Introduction to Transfer Pricing

Transfer pricing refers to the rules and methods for pricing transactions within and between enterprises under common ownership or control.

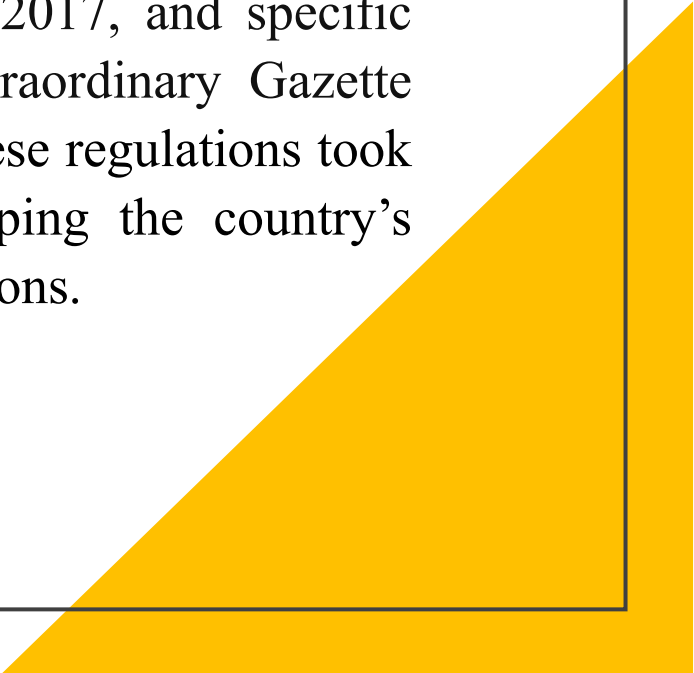
The aim is to ensure that transactions are conducted at arm's length, meaning the prices are consistent with those that would be charged between unrelated parties.



# Transfer Pricing Regulations

- **Legal Framework in Sri Lanka**

The transfer pricing regulations in Sri Lanka are governed by the apply to both international transact Inland Revenue Act, No. 24 of 2017, and specific regulations published in the Extraordinary Gazette No. 2217/7 dated 02.03.2021. These regulations took effect on the above date, reshaping the country's approach to related-party transactions.



# Transfer Pricing Regulations

Transfer Pricing Regulations apply to **International Transactions** referred to in section 76, and to the following cases of transactions made between associated enterprises from transactions referred to in section 77 [**domestic transaction**] of the Inland Revenue Act, No. 24 of 2017:

- (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 Inland Revenue Act, 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 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 the year of assessment





# Transfer Pricing Regulations

## Arm's Length Price

The arm's length price, 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** (referred to as the controlled transaction) should be calculated in accordance with the arm's length principle.

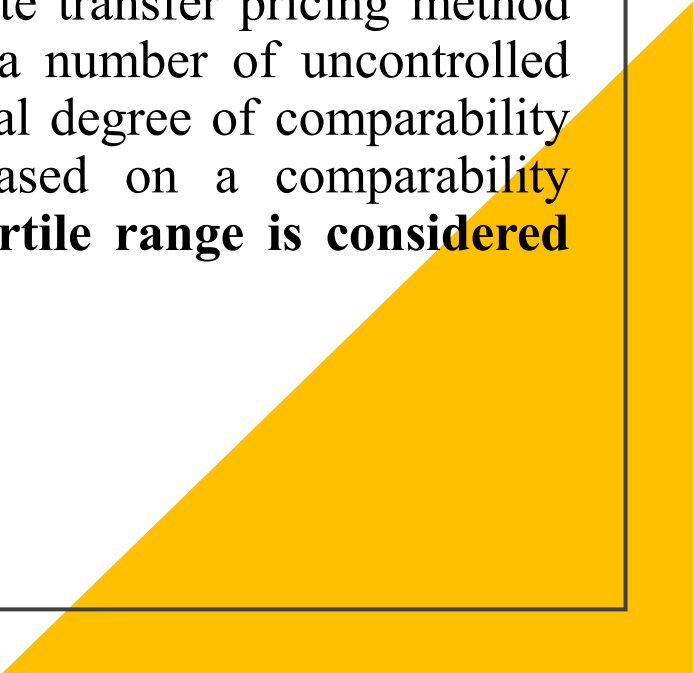
The arm's length principle shall be understood as that where a transaction between associated enterprises is carried out considering the terms and conditions that would have been used in transactions with or between independent enterprises



# Transfer Pricing Regulations

## Arm's Length Range

An arm's length range is a range of relevant financial indicator figures (e.g. prices or margins) produced by the application of the most appropriate transfer pricing method as set out in this regulation, to a number of uncontrolled transactions with a relatively equal degree of comparability to the controlled transaction based on a comparability analysis conducted, the **interquartile range is considered to be the arm's length range**



# Transfer Pricing Regulations

## Transfer Pricing Methods

In **Transfer Pricing (TP)**, **FAR** is a fundamental concept used in determining the **arm's length price**.

- It refers to the **FAR Analysis**, which is a core step in TP documentation and benchmarking.
- **FAR = Functions performed, Assets employed, and Risks assumed**

## Components of FAR

### 1. Functions (F) – What the entity does

- This includes all key activities performed by the entity, such as:
- Manufacturing / processing, Distribution / trading, Marketing and sales, Procurement, Research & development (R&D), Administrative and support services

Helps identify the **role of the entity** (e.g., manufacturer, distributor, service provider).



# Transfer Pricing Regulations

## Transfer Pricing Methods

In **Transfer Pricing (TP)**, **FAR** is a fundamental concept used in determining the **arm's length price (Contd...)**

### 2. Assets (A) – What the entity uses

This includes both:

- **Tangible assets:** plant & machinery, buildings, equipment
- **Intangible assets:** brands, patents, trademarks, technology, software

Determines the **value contribution** and capacity of the entity.

### 3. Risks (R) – What the entity bears

Typical risks include: Market risk, Credit risk, Inventory risk, Foreign exchange risk, Product liability risk, Operational risk

Higher risk = higher expected return (profit margin).



# Transfer Pricing Regulations

## Transfer Pricing Methods

In **Transfer Pricing (TP)**, **FAR** is a fundamental concept used in determining the **arm's length price (Contd...)**

## Purpose of FAR Analysis

- To determine **which entity performs what role** in a transaction
- To identify the **most appropriate transfer pricing method**
- To select **comparable companies**
- To justify **profit allocation** between related parties

e.g. if a Sri Lankan company:

- Only performs **routine distribution**,
- Uses limited assets,
- Bears minimal risk (e.g., no inventory risk),

It will be classified as a **low-risk distributor**, Hence, it should earn a **lower, stable margin** (compared to a full-fledged entrepreneur).



# Transfer Pricing Regulations

## Transfer Pricing Methods

1. **Comparable Uncontrolled Price (CUP) Method:** Compares the price charged in a controlled transaction to the price charged in a comparable uncontrolled transaction.
2. **Resale Price Method (RPM):** Focuses on the resale price of a product purchased from an associated enterprise and sold to an independent party.
3. **Cost Plus Method (CPM):** Adds an appropriate markup to the costs incurred by the supplier of goods or services in a controlled transaction.
4. **Transactional Net Margin Method (TNMM):** Examines the net profit margin relative to an appropriate base (e.g., costs, sales) that a taxpayer realizes from a controlled transaction.
5. **Profit Split Method (PSM):** Divides the combined profits from controlled transactions among the associated enterprises based on their relative contributions.



# Transfer Pricing Regulations

## Transfer Pricing Methods

Transfer pricing methods are techniques used to determine the arm's length price of related-party transactions. These include traditional methods such as CUP, RPM, and Cost Plus, as well as transactional methods like TNMM and Profit Split. The selection of the method depends on the nature of the transaction, availability of comparables, and FAR analysis of the entities involved.

## Comparable Uncontrolled Price (CUP) Method

**Concept:** Compares the price charged in a **controlled transaction** with the price charged in a **similar uncontrolled transaction**.

**Example:** A Sri Lankan company sells garments to its related company at **USD 4 per unit**. The same company sells similar garments to an **independent customer at USD 5 per unit**

- Arm's length price = USD 5
- Adjustment = Increase price from USD 4 → USD 5



# Transfer Pricing Regulations

## Transfer Pricing Methods (Contd..)

### Comparable Uncontrolled Price (CUP) Method...

#### Best used when:

- Identical or very similar products are available
- Market data is reliable

### Resale Price Method (RPM)

**Concept:** Starts with the **resale price to third parties**, then deducts a **gross margin** to arrive at the transfer price.

#### Example

- Subsidiary buys goods from parent and sells to customers at **Rs. 1,000**, Comparable gross margin = **20%**
- Transfer price =  $1,000 - (20\% \times 1,000) = \text{Rs. } 800$

#### Best used when:

- Distributor does not add much value
- No major processing is done



# Transfer Pricing Regulations

## Transfer Pricing Methods (Contd..)

### Cost Plus Method (CPM)

**Concept:** Adds an appropriate **mark-up to cost** incurred by the supplier.

#### Example

- Manufacturing cost = Rs. 500
- Arm's length mark-up = 25%

Transfer price =  $500 + (25\% \times 500) = \text{Rs. } 625$

#### Best used when:

- Semi-finished goods
- Contract manufacturing / services



# Transfer Pricing Regulations

## Transfer Pricing Methods (Contd..)

- **Transactional Net Margin Method (TNMM)**

**Concept:** Examines the **net profit margin** relative to an appropriate base (cost, sales, etc.).

**Example**

- Company earns **net profit margin = 3% on sales**
- Comparable independent companies earn **6%**

Adjustment required to increase profit margin to 6%

**Best used when:**

- Data for gross margins not reliable
- Most commonly used method in practice

TNMM heavily depends on TP databases



# Transfer Pricing Regulations

## Transfer Pricing Methods (Contd..)

### Profit Split Method (PSM)

**Concept:** Profit from a transaction is **split between related parties** based on their contribution (FAR analysis).

#### Example

- Total profit from a joint project = Rs. 10 Mn
- Entity A contributes 60%, Entity B contributes 40%

A gets Rs. 6 Mn. B gets Rs. 4 Mn

#### Best used when:

- Highly integrated operations
- Both parties contribute valuable intangibles



# Transfer Pricing Regulations

## Key Requirements

### Transfer Pricing Disclosure Form (TPDF):

All taxpayers with international transactions or specified domestic transactions must submit a TPDF along with their income tax return.

The form must be completed if the aggregate value of transactions exceeds **LKR 200 million**.

### Documentation:

Taxpayers must maintain detailed documentation to substantiate that their transfer pricing is consistent with the arm's length principle.

This includes information on the nature of the transactions, the associated enterprises involved, and the transfer pricing methods used.



# Transfer Pricing Regulations

## Key Requirements

In Sri Lanka, the requirements for maintaining a Master File and a Local File for transfer pricing purposes are clearly defined.

## Local File

The Local File is to be prepared and maintained by those enterprises that carry out aggregate 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 the Regulation (The transaction here does not include dividend and granting or repayment of loan Capital).



# Transfer Pricing Regulations

## Key Requirements

### Master File.

The Master File is required for multinational enterprise (MNE) groups with total consolidated group revenue exceeding EUR 50 million (or its equivalent in Sri Lankan Rupees). This file should provide a comprehensive overview of the MNE group's global business operations and transfer pricing policies.

Master File and a Local File shall be submitted by the taxpayer **within 60 calendar days of the written request being duly issued by the Commissioner General of Inland.**



# Transfer Pricing Regulations

## Key Requirements

### Country-by-Country Report (CbCR) :

In Sri Lanka, the submission of the Country-by-Country Report (CbCR) is mandated for **Multinational Enterprise (MNE) groups** with total consolidated group revenue of not less than **EUR 750 million or its equivalent in Sri Lankan Rupees**.

The CbCR must be filed by the ultimate parent entity or a surrogate parent entity of the MNE group. The report should be submitted to the Inland Revenue Department (IRD) by December 31st of the year following the fiscal year to which the report relates.

The Country-by-Country Report required by Paragraph (e) of this regulation shall be filed no later than 12 months after the last day of the Reporting Fiscal Year of the MNE Group



# Transfer Pricing Regulations

## Key Requirements

### Country-by-Country Report (CbCR) ....

**Group** means a collection of enterprises related through ownership or control such that it is either **required to prepare Consolidated Financial Statements for financial reporting purposes under applicable accounting principles** or would be so required if equity interests in any of the enterprises were traded on a public securities exchange.

### **Multinational Enterprise (MNE)**

- (a) includes **two or more enterprises the tax residence for which is in different jurisdictions**, 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
- (b) is not an **Excluded MNE Group**



# Transfer Pricing Regulations

## Key Requirements

### Country-by-Country Report (CbCR) ....

**Excluded MNE Group** means, with respect to any Fiscal Year of the Group, a Group having total consolidated group revenue of less than 750 million Euro or its equivalent in Sri Lanka Rupees during the Fiscal Year immediately preceding the Reporting Fiscal Year as reflected in its Consolidated Financial Statements for such preceding Fiscal Year.



# Transfer Pricing Regulations

## Key Requirements

### Country-by-Country Report (CbCR) ....

### The Reporting Entity

The Constituent Entity (CE) that is required to file a Country by-Country report as per the regulation in its jurisdiction of tax residence on behalf of the MNE Group. The Reporting Entity may be the Ultimate Parent Entity (UPE), the Surrogate Parent Entity (SPE), or any entity described in the regulation.



# Transfer Pricing Regulations

## Key Requirements

### Country-by-Country Report (CbCR) ....

**Ultimate Parent Entity** means a Constituent Entity of an MNE Group that meets the following criteria:

- a) it owns directly or indirectly a sufficient interest in one or more other Constituent Entities of such MNE Group such that it is required to prepare Consolidated Financial Statements under accounting principles generally applied in its jurisdiction of tax residence, or would be so required if its equity interests were traded on a public securities exchange in its jurisdiction of tax residence; and



# Transfer Pricing Regulations

## Key Requirements

### Country-by-Country Report (CbCR) ....

#### Ultimate Parent Entity means ....

- b) there is no other Constituent Entity of such MNE Group that owns directly or indirectly an interest described in the regulation.

**Surrogate Parent Entity** means one Constituent Entity of the MNE Group that has been appointed by such MNE Group, as a sole substitute for the Ultimate Parent Entity, to file the Country-by-Country Report in that Constituent Entity's jurisdiction of tax residence, on behalf of such MNE Group, when one or more of the conditions set out in the regulation applies.



# Transfer Pricing Regulations

## Key Requirements

**Country-by-Country Report (CbCR) ....**

**Ultimate Parent Entity** means .....

**Fiscal Year** means an annual accounting period with respect to which the Ultimate Parent Entity of the MNE Group prepares its financial statements



# Transfer Pricing Regulations

## Key Requirements

### Country-by-Country Report (CbCR) ....

#### CbCR Notification

- (i) Any Constituent Entity of an MNE Group that is resident for tax purposes in Sri Lanka shall notify Commissioner General whether it is the Ultimate Parent Entity or the Surrogate Parent Entity, **no later than December 31st** of the Reporting Fiscal Year of such MNE Group.
- (ii) Where a Constituent Entity of an MNE Group that is resident for tax purposes in Sri Lanka is not the Ultimate Parent Entity nor the Surrogate Parent Entity, it shall notify the Commissioner General of the identity and tax residence of the Reporting Entity, **no later than December 31st** of the Reporting Fiscal Year of such MNE Group.



# Transfer Pricing Regulations

## Practical Steps for Compliance

1. Identify Associated Enterprises: Determine which entities are considered associated enterprises under the regulations.
2. Analyze Transactions: Review all transactions with associated enterprises to identify those that meet the threshold for transfer pricing documentation.
3. Select Appropriate Method: Choose the most suitable transfer pricing method based on the nature of the transactions.
4. Prepare Documentation: Maintain comprehensive documentation to support the transfer pricing method and ensure it aligns with the arm's length principle.
5. File TPDF: Complete and submit the TPDF along with the annual income tax return.



# Transfer Pricing Regulations

## Transfer pricing penalties

Where any person fails to comply with the requirements, of section 76 or 77 in relation to transactions with associated enterprises, the Commissioner- General may impose on such person

- a penalty of a sum not exceeding one *per centum* of aggregate value of transactions with associated enterprises, where required documents have not been maintained;
- a penalty of a sum not exceeding two hundred and fifty thousand rupees, where required documents have not been submitted;
- a penalty of a sum not exceeding two *per centum* of aggregate value of transactions with its associated enterprises, in case of non-disclosure of any required information;
- a penalty of a sum not exceeding one hundred thousand rupee



# Transfer Pricing Regulations

## Transfer pricing penalties

a penalty of two hundred *per centum* of the value of additional tax where such person has—

- (i) concealed the particulars of his income, or furnished inaccurate particulars of such income; and
- (ii) sought to evade by reason of concealment of particulars of his income or the furnishing of inaccurate particulars of such income,



# Transfer Pricing Regulations

Advance Pricing Agreements (APA) —

With a view to supplement the traditional administrative, judicial and treaty mechanisms for resolving transfer pricing issues, any person who has controlled international transactions can enter into an Advance Pricing Agreement with the Commissioner General.

An Advance Pricing Agreement determines, in advance of specified international transactions with associated enterprises (i.e. the controlled transactions covered by the agreement), an appropriate set of criteria (e.g. methodology, appropriate adjustments thereto, and critical assumptions as to the future events) for the determination of the arm's length price for those transactions over a fixed period of time.

# Transfer Pricing Regulations

Advance Pricing Agreements (APA) —

The agreements can basically be divided into the following two categories:

- (i) Unilateral Advance Pricing Agreements: Whereby the Commissioner General and the taxpayer come into an agreement with regard to a particular transaction between associated enterprises without involvement of other interested tax administrations, though it may affect the tax liability of the associated enterprise in other tax jurisdictions.
- (ii) Bilateral / Multilateral Advance Pricing Agreements: Where by two or more tax authorities in different jurisdictions come in to an agreement with regard to a particular transaction between associated enterprises. The bilateral or multilateral approach is considered equitable to all tax administrations and taxpayers and provides greater certainty to the taxpayer concerned.

# Transfer Pricing Regulations

Advance Pricing Agreements (APA) —

An Advance Pricing Agreement may be entered into between a taxpayer and the Commissioner-General in respect of the arm's length result of an international transaction with an associate enterprise

## **The safe harbour rule**

This rule in transfer pricing refers to a provision that allows certain taxpayers to follow simplified transfer pricing regulations under predefined conditions. When these conditions are met, the tax authorities will accept the transfer prices declared by the taxpayer without further scrutiny.

