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EXTRAORDINARY

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PART I : SECTION (I) — GENERAL

Government Notifications

INLAND REVENUE ACT No. 10 OF 2006

REGULATIONS made by the Minister of Finance under the Section 212 of the Inland Revenue Act, No. 10 of 2006 read with Section 104(3) and (4) of such Inland Revenue Act.

RANJITH SIYAMBALAPITIYA,
Acting Minister of Finance and Planning.

11th April, 2008,
Ministry of Finance and Planning,
Colombo 01.

Regulations

1. These regulations may be cited as "*Transfer pricing regulations*".

2. *Arm's Length Price*.—The arm's length price, referred to in Section 104(3) of the Inland Revenue Act No. 10 of 2006, for the purpose of ascertaining profits and income arising, derived or accruing from or loss incurred in any transaction entered into between two associated undertakings shall be determined by any of the following methods, being the most appropriate method :-

(a) *comparable uncontrolled price method*

under this method,

- (i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified ;
- (ii) such price is adjusted to account for differences, if any between the transaction and the comparable uncontrolled transactions or between the undertakings, entering into such transactions, which could materially affect the price in the open market ;
- (iii) the adjusted price so arrived at is taken to be an arm's length price in respect of the property transferred or services provided in the transaction ;

(b) *resale price method*

under this method

- (i) the price at which property purchased or services obtained by the undertaking from an associated undertaking is resold or are provided to an unrelated enterprise, is identified ;
- (ii) such resale price is reduced by the amount of a normal gross profit margin accruing to the undertaking or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions ;
- (iii) the price so arrived at is further reduced by the expenses incurred by the undertaking in connection with the purchase of property or obtaining of services ;
- (iv) the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the transaction and the comparable uncontrolled transactions, or between the undertakings entering into such transactions, which could materially affect the amount of gross profit margin in the open market ;
- (v) the adjusted price arrived at under sub-clause (iv) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated undertaking ;

(c) *cost plus method*

under this method

- (i) the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated undertaking, are determined ;
- (ii) the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined ;
- (iii) the normal gross profit mark-up referred to in (ii) is adjusted to take into account the functional and other differences, if any, between the transaction and the comparable uncontrolled transactions, or between the undertakings entering into such transactions, which could materially affect such profit mark-up in the open market ;
- (iv) the costs referred to in (i) are increased by the adjusted profit mark-up arrived at under (iii) ;
- (v) the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the undertaking ;

(d) *Profit split method*

This method may be applicable mainly to international transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction, by which -

- (i) the combined net profit of the associated undertaking arising from the (international) transaction in which they are engaged, is determined ;

- (ii) the relative contribution made by each of the associated undertaking to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated undertaking performing comparable functions in similar circumstances ;
- (iii) the combined net profit is then split amongst the undertakings in proportion to their relative contributions, as evaluated under sub clause (ii) ;
- (iv) the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the transaction :

Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be partially allocated to each undertaking so as to provide it with a basic return appropriate for the type of transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the transaction ;

(e) *transactional net margin method* —

under this method,

- (i) the net profit margin realized by the undertaking from a transactions entered into with an associated undertaking is computed in relation to costs incurred or sales effected or assets employed or to be employed by the undertakings or housing regard to any other relevant base ;
- (ii) the net profit margin realized by the undertaking or by an unrelated undertaking from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same basis ;
- (iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the transaction and the comparable uncontrolled transactions, or between the undertakings entering into such transactions, which could materially affect the amount of net profit margin in the open market ;
- (iv) the net profit margin realized by the undertaking and referred to in (i) is established to be the same as the net profit margin referred to in (iii) ;
- (v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the transaction.

3. For the purposes of regulation 2, the comparability of a transaction with an uncontrolled transaction shall be judged with reference to the following :-

- (a) the specific characteristics of the property transferred or services provided in either transaction ;
- (b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transaction ;

- (c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions ;
- (d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

4. *An uncontrolled transaction shall be comparable to a transaction, if*

- (i) none of the differences, if any, between the transactions being compared, or between the undertaking entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market ; or
- (ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

The data to be used in analyzing the comparability of an uncontrolled transaction with a transaction shall be the date relating to the financial year in which the transaction has been entered into ;

Provided that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

5. *Most appropriate method :*

- (a) For the purposes of regulation (2), the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular transaction, and which provides the most reliable measure of an arm's length price in relation to the transaction.
- (b) In selecting the most appropriate method, the following factors shall be taken into account, namely :-
 - (i) the nature and class of the transaction ;
 - (ii) the class or classes of associated undertaking entering into the transaction and the functions performed by them taking into account the assets employed or to be employed and risks assumed by such enterprises ;
 - (iii) the availability, coverage and reliability of data necessary for application of the method ;
 - (iv) the degree of comparability existing between the transaction and the uncontrolled transaction and between the undertakings entering into such transactions ;
 - (v) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions ;
 - (vi) the nature, extent and reliability of assumptions required to be made in application of a method.

6. Every person who entered into a transaction shall keep and maintain the following information and documents :-

- (a) a description of the ownership structure of the assessee undertaking with details of shares or other ownership interest held therein by other undertaking ;

- (b) a profile of the multinational or group of which the assessee undertaking is a part along with the name, address, legal status and country of tax residence of which of the undertakings comprised in the multinational or group with whom transactions have been entered into by the assessee, and ownership linkages among them ;
- (c) a broad description of the business of the assessee and the industry in which the assessee operates, and of the business of the associated undertakings with whom the assessee has transacted ;
- (d) the nature and terms (including prices) of international or group transactions entered into with each associated undertaking, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction ;
- (e) a description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated undertaking involved in the transaction ;
- (f) a record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the transactions entered into by the assessee ;
- (g) a record of uncontrolled transactions taken into account for analyzing their comparability with the transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the in transactions ;
- (h) a record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant transaction ;
- (i) a description of the methods considered for determining the arm's length price in relation to each transaction or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected, and how such method was applied in each case ;
- (j) a record of the actual working carried out for the determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the transaction and the comparable uncontrolled transactions, or between the undertakings entering into such transactions ;
- (k) the assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price ;
- (l) details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these ruled and consequent adjustment made to the total income for tax purposes ;
- (m) any other information, data or document, including information or data relating to the associated undertaking, which may be relevant for determination of the arm's length price.

7. Nothing contained in aforesaid regulations shall apply in case where the aggregate value, as recorded in the books of account, of transactions entered in to by the assessee does not exceed 100 million rupees :

Provided that the assessee shall be required to substantiate, on the basis of material available with him, that income arising from transactions entered into by him has been computed in accordance with section 104(3).

The information specified shall be supported by authentic documents, which may include the following ;

- (a) official publications, reports, studies and data bases from the Government of the country of residence of the associated undertaking, or of any other country ;

- (b) reports of market research studies carried out and technical publications brought out by institutions of national or international repute ;
- (c) price publications including stock exchange and commodity market quotations ;
- (d) published accounts and financial statements relating to the businesses affairs of the associated undertaking ;
- (e) agreements and contracts entered into with associated undertaking or with unrelated enterprises in respect of transactions similar to that transactions ;
- (f) letters and other correspondence documenting any terms negotiated between the assessee and the associated undertaking ;
- (g) documents normally issued in connection with various transactions under the accounting practices followed.

The information and documents specified in regulation 6 shall be kept and maintained for a period of five years from the end of the relevant year of assessment.

8. *Advance pricing agreemenst (APA).*—With a view to supplement the traditional administrative, judicial and treaty mechanism for resolving transfer pricing issues, arrangements have been made for entering into an advance pricing agreement 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 arrangements can basically be divided in to the following two categories :

- (i) *Unilateral Arrangement* : It is an arrangement where the tax administration and the taxpayer establish an arrangement without involvement of other interested tax administrations though it may affect the tax liability of the associated enterprise in other tax jurisdictions
- (ii) *Bilateral Arrangement* : It is an arrangement in which two or more countries concur in regard to transfer pricing methodology to be adopted. The bilateral or multilateral approach is considered equitable to all tax administrations and taxpayers and provides greater certainty to the taxpayer concerned.

9. *Associated undertakings [section 104(4)].*—For the purposes of section 104(4) of the aforesaid Inland Revenue Act and the above regulations, two undertakings shall be deemed to be associated undertakings, if, at any time during the previous year,—

- (a) one enterprise holds, directly or indirectly, shares carrying not less than fifty per cent of the voting power in each of such undertaking ; or
- (b) any person or undertaking holds, directly or indirectly, shares carrying not less than fifty per cent of the voting power in each of such undertaking ; or
- (c) loans advanced by one undertaking to the other undertaking constitutes not less than fifty-one per cent of the book value of the total assets of the other undertaking ; or
- (d) one undertaking guarantees not less than twenty five per cent of the total borrowings of the other undertaking ; or
- (e) 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 undertaking, are appointed by the other undertaking ; or

- (f) more than half of the 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 undertakings are appointed by the same person or persons ; or
- (g) the manufacture or processing of goods or article or business carried out by one undertaking is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other undertaking is the owner or in respect of which the other undertaking has exclusive rights ; or
- (h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one undertaking, are supplied by the other undertaking, or by persons specified by the other undertaking, and the prices and other conditions relating to the supply are influenced by such other undertaking ; or
- (i) there exists between the two undertaking, any relationship of mutual interest, as may be prescribed.