Introduction to Transfer Pricing – Sri Lanka

1. What is transfer price?

2. Transfer pricing law and regulations

3. Preparing transfer pricing documentation

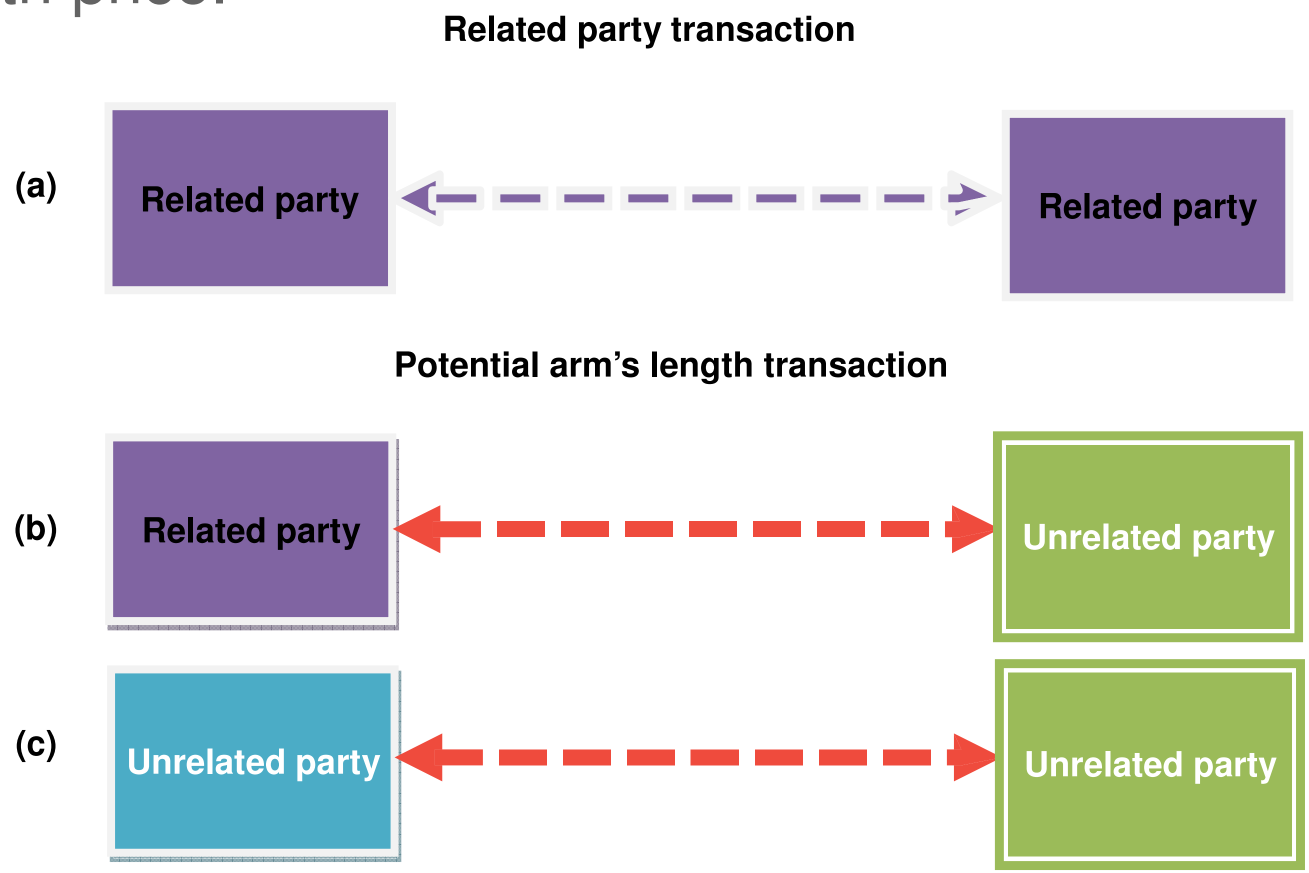
4. Suggested approaches for pricing documentation

What is transfer price?

- Transfer price is the price at which an entity transfers physical goods, intangibles or services to related parties.

What is arm’s length price?

- The price which would be expected to be seen between unrelated parties are generally referred to as the arm's length price.



Major economies with effective TP documentation rules*

1994-1997	1998-2000	2001-2002	2003-2004	2005-2012	
US	US	US	US	US	Ecuador
Australia	Australia	Australia	Australia	Australia	Philippines
France	France	France	France	France	Vietnam
Mexico	Mexico	Mexico	Mexico	Mexico	Singapore
Brazil	Brazil	Brazil	Brazil	Brazil	Sweden
	Canada	Canada	Canada	Canada	Israel
	South Korea	South Korea	South Korea	South Korea	Slovak Republic
	UK	UK	UK	UK	Finland
	Denmark	Denmark	Denmark	Denmark	Croatia
	Venezuela	Venezuela	Venezuela	Venezuela	Estonia
	South Africa	South Africa	South Africa	South Africa	Kenya
	Germany	Germany	Germany	Germany	Turkey
	Belgium	Belgium	Belgium	Belgium	China
		Japan	Japan	Japan	Hong Kong
		Poland	Poland	Poland	Italy
		Kazakhstan	Kazakhstan	Kazakhstan	Romania
		India	India	India	Greece
		Portugal	Portugal	Portugal	Austria
		Argentina	Argentina	Argentina	Russia
		Columbia	Colombia	Colombia	Egypt
		Netherlands	Netherlands	Netherlands	Latvia
		Thailand	Thailand	Thailand	Uruguay
			Malaysia	Malaysia	Switzerland
			Indonesia	Indonesia	Ireland
			Norway	Norway	El Salvador
			New Zealand	New Zealand	Panama
			Peru	Peru	Luxembourg
			Spain	Spain	Uganda
			Taiwan	Taiwan	Dominican Republic
			Hungary	Hungary	Macedonia
			Lithuania	Lithuania	Honduras
					Guatemala
					Ghana
					Nigeria

*Effective indicates that either the country has specific legislation or regulations regarding TP documentation or other guidance strongly suggests that transfer documentation should be in place

Transfer pricing law and regulations

1

Sections 104 and 104A of the Inland Revenue Act (IRA) require that both international and local transactions with associated undertakings are ascertained having regard to the arm's length price for tax purposes.

2

In April 2008, the Government introduced transfer pricing (TP) regulations for the first time in Sri Lanka.

However, these regulations were not strictly Implemented.

3

In August 2013, a new set of TP regulations was issued mandating taxpayers to comply with them effective from 1 April 2013.

4

Another Gazette was issued in March 2015 requiring taxpayers to file summarized details of their transactions with associated undertakings along with an audit certification at the time of filing Income Tax Returns (YA 2015/16 onwards)

What is required under the law and TP regulations

Requirement	Applicability
1. File Auditor’s Certificate along with summarized details of transactions with associated undertakings at the time of filing Income Tax Returns	YA 2015/16 onwards
2. Make disclosures in the Director’s Report as required by the Gazette	YA 2013/14 onwards
3. Issue a Certificate of the Director / Principal Officer on TP along with a Directors’ Report	YA 2013/14 onwards
4. Prepare TP documentation supporting the arm’s length nature of transactions with associated undertakings	YA 2008/09 onwards

Summary of details required by the Gazette issued in March 2015

Transaction with associated undertakings / Information Required	Purchase / sale of raw materials and others	Purchase / sale of finished goods	Purchase / sale / lease of properties	Use of intangible properties	Services	Loans and advances	Allocation of costs
Name and address of the related party	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Description of the transaction	Yes	Yes	Yes	Yes	Yes	Yes *	Yes
Quantity involved	Yes	Yes	Yes	-	-	-	-
Amounts as per financial statements	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Amounts as computed having regard to the arm's length price	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Pricing method used to determine the arm's length price	Yes	Yes	Yes	Yes	Yes	Yes	Yes

* Taxpayer is required to disclose the nature of financing arrangement, currency used and interest rate applied.

Audit Certification required

- I/We have examined the accounts and records of .... (name of the Taxpayer with TIN Number) relating to the transactions entered into with associated undertakings by the Taxpayer during the year of assessment ending on 31st March ....
- In my/our opinion proper information and documents as prescribed **have been kept/have not been kept by the Taxpayer** in respect of the transaction(s) entered into so far with associated undertakings as appears from my/our examination of the records of the Taxpayer.
- The particulars required to be furnished under Regulation 9 of Gazette Extraordinary No. 1823/5 of 12.08.2013 are stated in this certificate. **In my/our opinion and to the best of my/our information and according to the explanations given to me/us, I/we certify that all material information and particulars have been given.**

....

Name: Signature of Approved Accountant.

Address:

Date:

Disclosures in the Director's Report

- The record of transactions entered into with associated undertaking (the format as specified under section 107(2)(a) of the IRA)
- Transfer Pricing Policy Statement describing the strategies and policies influencing the determination of transfer price
- Management perception of risk factors involved
- The amounts or appropriate proportions of outstanding items pertaining to related party balances and provisions for doubtful debts due from such parties as on Balance Sheet date
- Any other material information

Format of the Certificate of the Director / Principal Officer on transfer pricing

To the Members,

It is certified that the company has complied with the Transfer Pricing Regulations issued under Section 104 of the Inland Revenue Act, No. 10 of 2006. The information pursuant to these Regulations is given under certificate produced under Section 107(2)(a) of the said Act. We believe that the record of transactions entered into with related parties during the period from .... to .... are at arm's length and not prejudicial to the interests of the company. The transactions are entered into on the basis of a transfer pricing policy adopted by the company. All transactions have been submitted to the independent auditors for audit. [No adverse remarks have been made in their report on the audit of such transactions] / [The auditors have qualified their report and the audit report is attached].*

Place :

For and on behalf of the
Board of Directors.

** Delete whichever is not applicable*

Types of documents required under the TP regulations

- TP regulations do not prescribe any type or format for the TP report. Therefore, any type or format of record should be acceptable to the extent that at a minimum it includes the following:
  1. Group profile / ownership structure
  2. Industry / business details
  3. Functions performed, risks assumed and assets employed
  4. Economic and market analysis, forecasts, budgets or estimates
  5. A record of uncontrolled transactions
  6. Rationale for selecting the TP method
  7. A record of actual workings carried out for the determination of the arm's length price
  8. Assumptions, policies, price negotiations influencing the determination of the arm's length price
  9. TP adjustments

Basis of determination of associated undertakings

- Associated undertakings are determined based on the fulfilment of the following conditions.

Ownership and control	1. 50% or more voting power through share ownership 2. 50% or more representation in the Board or power to appoint one or more Executive Directors / members 3. Common control by an individual or jointly by such individual and his relative 4. 10% or more interest in the case of a firm, association or body of individuals
Transactions	1. Complete dependence on know-how, patent etc. for manufacturing 2. Supply of 90% or more of the raw materials and consumables 3. Loans exceeding 51% of total assets 4. Guarantees exceeding 25% of the total borrowings

Arm's length price as per IR Act

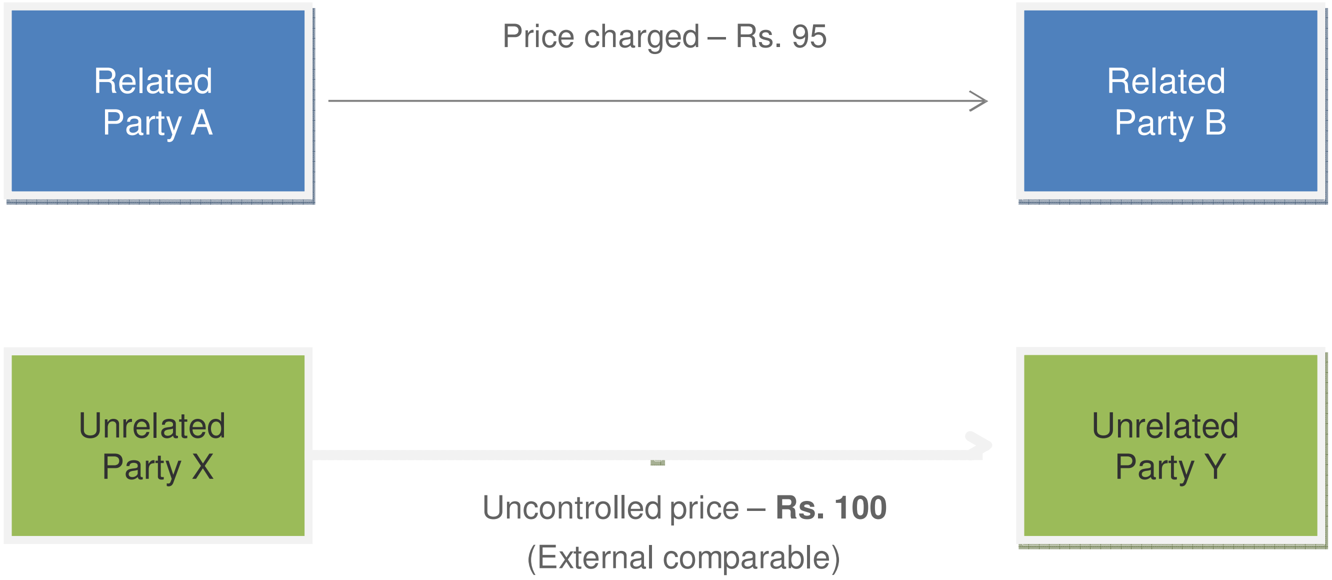
- Under the IRA, **"arms length price"** means a price which is applied in uncontrolled conditions in a transaction between persons other than associated undertakings.
- The arm's length price shall be determined on the basis of any one or more of the following methods prescribed.

  1. Comparable uncontrolled price (CUP) method
  2. Resale price method
  3. Cost plus (Cost +) method
  4. Transactional net margin method (TNMM)
  5. Profit split method

Pricing methods - CUP method

The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

Example



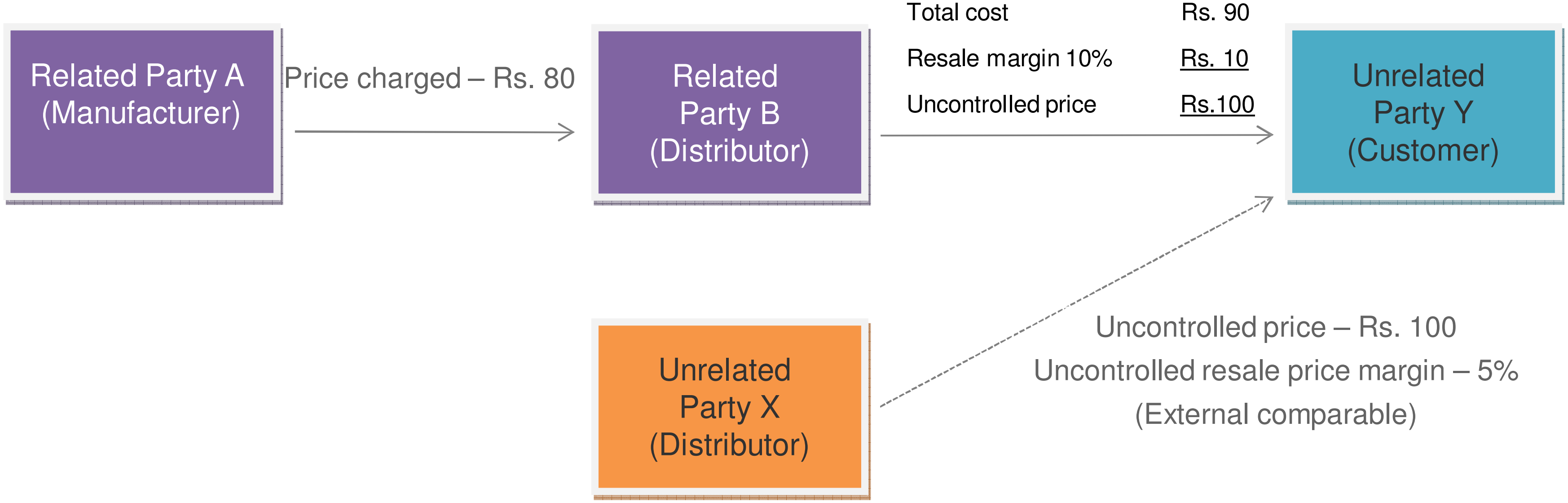
Transfer price = Rs. 100

Pricing methods - Resale price method

A transfer pricing method where the resale price to the independent party is reduced by a comparable resale price margin to arrive at the arm's length price of the product transferred between the related parties.

Example

Purchase cost	Rs. 80
Own cost	Rs. 10
Total cost	Rs. 90
Resale margin 10%	Rs. 10
Uncontrolled price	Rs.100



Transfer price = Rs. 100 – (Expenses of B + Resale price margin of 5%)

= Rs. 100 – (Rs. 10 + Rs. 5)

= Rs. 85

Pricing methods - Cost + method

A transfer pricing method where a comparable gross mark up is added to the costs incurred by the supplier of goods or services in a related party transaction to arrive at the arm's length price of that transaction.

Example

Related Party A → Related Party B

Cost	- Rs. 100
GP margin of 10%	- Rs. 10
Price charged	- Rs. 110

Unrelated Party X → Unrelated Party Y

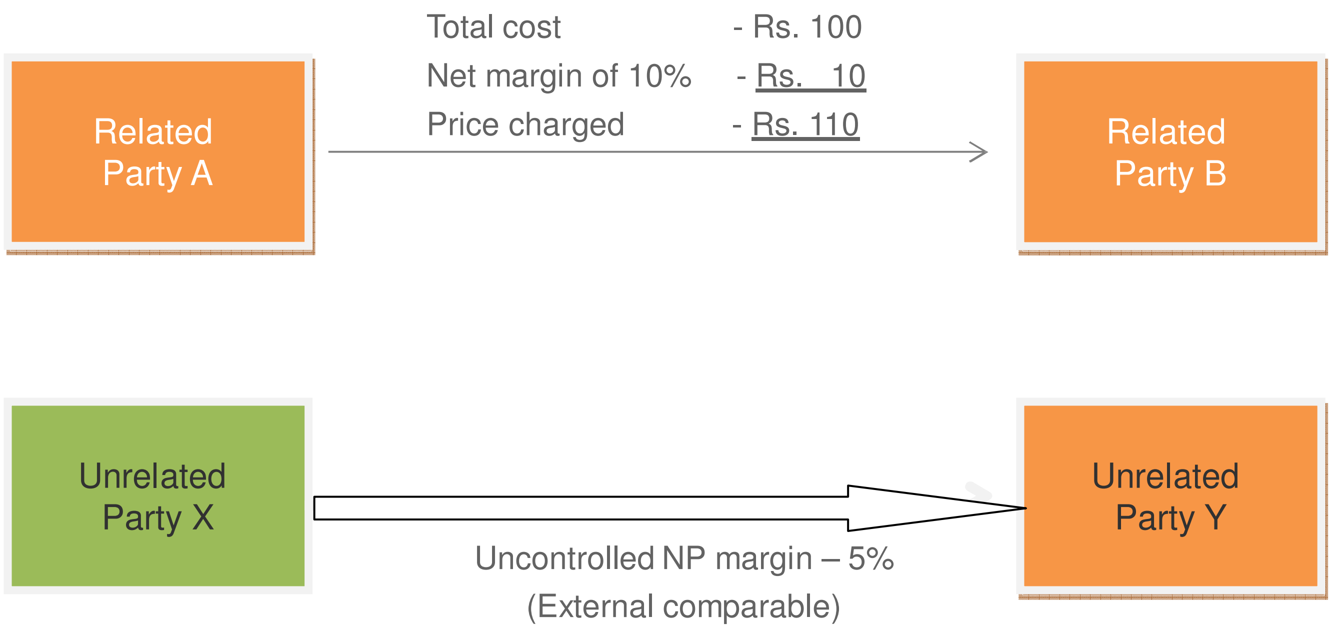
Uncontrolled GP margin – 5%
(External comparable)

Transfer price = Cost + Uncontrolled GP margin of 5%
= Rs. 100 + Rs. 5
= Rs. 105

Pricing methods - TNMM

A transfer pricing method that compares the net profit relative to an appropriate base (for example, costs, sales, assets) that is attained by a taxpayer from a related party transaction to that of comparable independent parties.

Example



Transfer price = Cost + Uncontrolled net margin of 5%
= Rs. 100 + Rs. 5
= Rs. 105

Pricing methods - Profit split method

A transfer pricing method that is based on the concept of splitting the combined profits of a transaction between related parties in a similar way as how independent parties would under comparable circumstances.

Example

Company A is a Sri Lankan manufacturing and sales company for telecommunication products. It developed an original microprocessor and holds the patent for the manufacturing technology. Company B, an overseas subsidiary of Company A, develops and manufactures mobile phones using the new microprocessor as well as technology developed by itself.

Company B is the only manufacturer licensed by Company A to use the new microprocessor. Company A purchases all of the mobile phones manufactured by Company B and sells them to third parties.

Both companies contribute to the success of the mobile phone through their design of the microprocessor and the equipment. As the nature of the products is very advanced and unique, the Group is unable to locate any comparable with similar intangible assets. Therefore, neither the traditional methods (i.e. CUP, cost plus and resale price methods) nor the TNMM is appropriate in this case.

Nevertheless, the Group is able to obtain reliable data on mobile phone contract manufacturers and equipment wholesalers without unique intangible property in the telecommunication industry. The manufacturers earn a mark up of 10% while the wholesalers derive a 25% margin on sales.

Company A's and Company B's respective share of profit is determined in two stages using the transactional profit split method (residual analysis approach).

Pricing methods - Profit split method (cont.)

The simplified accounts of Company A and Company B are shown below:

	Company A Rs.	Company B Rs.
Sales	125	100
Cost of sales	(100)	(60)
Gross margin	25	40
Sales, general and administration expenses	(15)	(5)
Operating margin	**10**	**35**

The total operating margin for the Group is Rs. 45.

Step 1 – Determining the return for routine contributions

	Company A Rs.
Sales to third party customers	125
Resale margin of wholesale comparables	25%
Resale margin	**31.25**

	Company B Rs.
Cost of goods sold	60
Margin (Rs. 60 X 10%)	6
Transfer price (without intangibles)	**66**

Pricing methods - Profit split method (cont.)

Computation of return for routine contributions based on comparables (without intangibles)

	Company A Rs.	Company B Rs.
Sales		66
Cost of sales		(60)
Gross margin	31.25	6
Sales, general and administration expenses	(15.00)	(5)
Operating margin	**16.25**	**1**

The total operating margin for the Group is Rs. 17.25

Step 2 – Dividing the residual profit

The residual profit of the Group = Rs. 45 – Rs. 17.25 = Rs. 27.75

On further study of the two companies, two particular expense items, research and development ("R&D") expenses and marketing expenses, are identified as contributing to the key intangibles critical to the success of the mobile equipment. The R&D expenses and marketing expenses incurred by each company are as follows:

Company A	Rs. 12 million (80%)
Company B	Rs. 3 million (20%)

Pricing methods - Profit split method (cont.)

Assuming that the R&D and marketing expenses are equally significant in contributing to the residual profit, based on the proportionate expenses incurred:

Company A's share of residual profit (80% x Rs. 27.75) Rs. 22.20
Company B's share of residual profit (20% x Rs. 27.75) Rs. 5.55

Therefore, the adjusted operating profits of each company are as follows:

Company A = Rs. 22.20 + Rs. 16.25 = Rs. 38.45
Company B = Rs. 5.55 + Rs. 1 = Rs. 6.55

The adjusted tax accounts are as follows:

	Company A Rs.	Company B Rs.
Sales	125.00	71.55
Cost of sales	(71.55)	(60.00)
Gross margin	53.45	11.55
Sales, general and administration expenses	(15.00)	(5.00)
Operating margin	**38.45**	**6.55**

Hence, the transfer price determined using the transactional profit split method (residual analysis approach) should be Rs. 71.55.

How do you select the most appropriate pricing method

- The selection of a TP method serves to find the most appropriate method for a particular case. Considerations involved in selecting a method can include:
  1. the respective strengths and weaknesses of each method;
  2. the nature of the controlled transaction;
  3. the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method;
  4. the degree of comparability between the controlled and uncontrolled transactions;
  5. 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; and
  6. the nature, extent and reliability of assumptions required to be made in application of a method.

How to do the comparability analysis?

Are there differences in

- **Characteristics** of the property transferred or services provided?
- The **functions** performed, taking into account **assets** employed and **risks** assumed?
- The **contractual terms** of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between respective parties to the transaction?
- **Conditions prevailing in the market** in which the respective parties to the transaction operate?

No

Comparable transaction

Yes

Can the reasonably accurate **adjustments** be made to eliminate the material effects of such differences?

Yes

Comparable transaction

No

Non – comparable transaction

TP documentation requirement

- Taxpayers are required to keep **contemporaneous documentation** in English, if the transaction value exceeds Rs. 100 million for cross-border transactions and Rs. 50 million for domestic transactions for any year of assessment.
  - *As a general rule, all transactions with associated undertakings have to be carried out at arm's length and proper records should exist even if they fall bellow the above thresholds.*
- TP regulations require taxpayers to retain documents for a period of **five years** following the year of assessment.

Transfer pricing documentation

- Adequate documentation will make it easier for the IRD to review a taxpayer's TP analysis and thereby contribute to avoiding a dispute or to a timely resolution of any TP disputes that may arise. Hence, it is the key for supporting the arm's length basis of a taxpayer's transactions with associated undertakings
- Is a combination of factual and technical content. The factual content relates to:
  - Industry analysis
  - Business overview/business model
  - Functional/process analysis

  The technical content relates to:
  - Explaining the selection of an appropriate transfer pricing method
  - Applying that transfer pricing method
- TP documentation is not purely intercompany invoices and contracts

Typical TP documentation process

Regulation	Process	Remarks
Regulation 7 or 13, 5 (b) or 12 (b)	**1.** **Identify associated undertakings and their controlled transactions**	
Regulation 5 (a) (vi) or 12 (a) (vi)	**2.** **Perform industry analysis**	The purpose of the industry analysis is to identify the key aspects of the industry dynamics that typically impact on the way the intra-group transactions are structured in the industry. This might include: • References that show the transaction is common in the industry • Analysis of pricing indices or lack of the same in the industry • Key drivers of financial success • Risks relating to competition, regulation, changes in industry structure and trends

Typical TP documentation process (cont.)

Regulation	Process	Remarks
Regulation 5 (a) (i), (ii) (iii) and (iv) or 12 (a) (i), (ii) (iii) and (iv)	**3.** **Perform Group / Company analysis**	The Group / Company analysis provides an overview of the company's business, the companies involved in the intra-group transactions, including relevant legal and organizational structures. This analysis should explain how the taxpayer and its related parties fit into the industry, including: • History of the businesses • Nature of the business model used – is it the same as the industry norm or different and link this to the intercompany transaction • Nature of the products, services, intangible property or other that are the subject of the intercompany transaction • Summary of transfer pricing policy used for the intercompany transaction • Key financial information relating to the transaction and applicable entities
Regulation 5 (a) (v) or 12 (a) (v)	**4.** **Perform functional analysis**	The functional analysis identifies and explains the key value driving functions relating to the intra-group transactions, including how risks are assumed and (intangible) assets owned and utilized.

Typical TP documentation process (cont.)

Regulation	Process	Remarks
Regulation 1, 3, 4, 5 (a) (ix) or 12 (a) (ix)	**5.** **Development of transfer pricing setup**	This includes the following: • Identify and understand the intra-group transactions and identify the characteristics that would make a particular transaction or function suitable for use as a comparable; • Identify the most appropriate pricing method that produces the most reliable results and any alternative methods, if any; • Determine the choice of tested party and identify the profit level indicator; • Select comparables i.e., internal or external • Determine any necessary adjustments to the comparables; • Determine whether to evaluate transactions on a separate or aggregate basis; • Use of multiple year data; • Basis of obtaining internal comparables from other Group entities; • Basis of obtaining external comparables i.e., commercial databases, publicly available information, non-local comparables, loss generating comparables etc.; • Basis of selecting industry classification codes, independence criteria to be used, alignment of financial years etc.

Typical TP documentation process (cont.)

Regulation	Process	Remarks
Regulation 2, 3, 5 (a) (vii), (viii), (x), (xi), (xii) and (xiii) or 12 (a) (vii), (viii), (x), (xi), (xii) and (xiii), 5(c) or 12 (c)	**6. Perform economic analysis**	The purpose of an economic analysis is to explain how the taxpayer has applied the selected TP method to the applicable transaction. The application of the TP method typically relies on reference to benchmarking, as well as reference to how this benchmarking data should be interpreted relative the intercompany transaction. The benchmarking search should include the following: • An explanation of the process used to identify benchmarking data • The results from undertaking a benchmarking analysis • Whether adjustments were made to the data in the benchmarking analysis and why • How the data should be interpreted in terms of substantiating the arm's length nature of the taxpayer's transaction • Detailed appendices that show the process used and data generated/used in the search
Regulation 5 (b) or 12 (b)	**7. Conclusion**	The purpose of a conclusion is to summarise the key sections of the documentation, but specifically to "tie-together" the various sections of the documentation to support the contention that the taxpayer's transaction is arm's length. If the economic analysis does not support the arm's length outcome, then the following would typically be considered: • Re-assessment of the reliability of the TP method used • Re-structure the taxpayer's transaction to align with the third party data / practices • Prepare justification for why there is a difference between third party data and the taxpayer

Components of a typical TP documentation file

Industry analysis → **Group / Company analysis** → **Functional analysis** → **Method selection** → **Economic analysis** → **Conclusions**

Industry analysis + Group / Company analysis + Functional analysis + Method selection + Economic analysis + Conclusions = Transfer pricing document

Industry analysis	Group / Company analysis	Functional analysis	Method selection	Economic analysis
The purpose of the Industry analysis is to identify the key aspects of the industry dynamics that typically impact on the way the intra-group transactions are structured in the industry.	The Group / Company analysis provides an overview of the company's business, the companies involved in the intra-group transactions, including relevant legal and organizational structures.	The functional analysis identifies and explains the key value driving functions relating to the intra-group transactions, including how risks are assumed and (intangible) assets owned and utilized.	This section outlines how the Group has considered the applicability of the five recognised transfer pricing methods in relation to the intra-group transactions.	The economic analysis outlines how the selected transfer pricing method(s) has been applied to substantiate that the transactions between the applicable entities are consistent with the arm's length principle. This section will include the regional and country specific benchmarking analysis.

Transfer pricing documentation based on the recommendations of the 2010 OECD Transfer Pricing Guidelines.

End.