



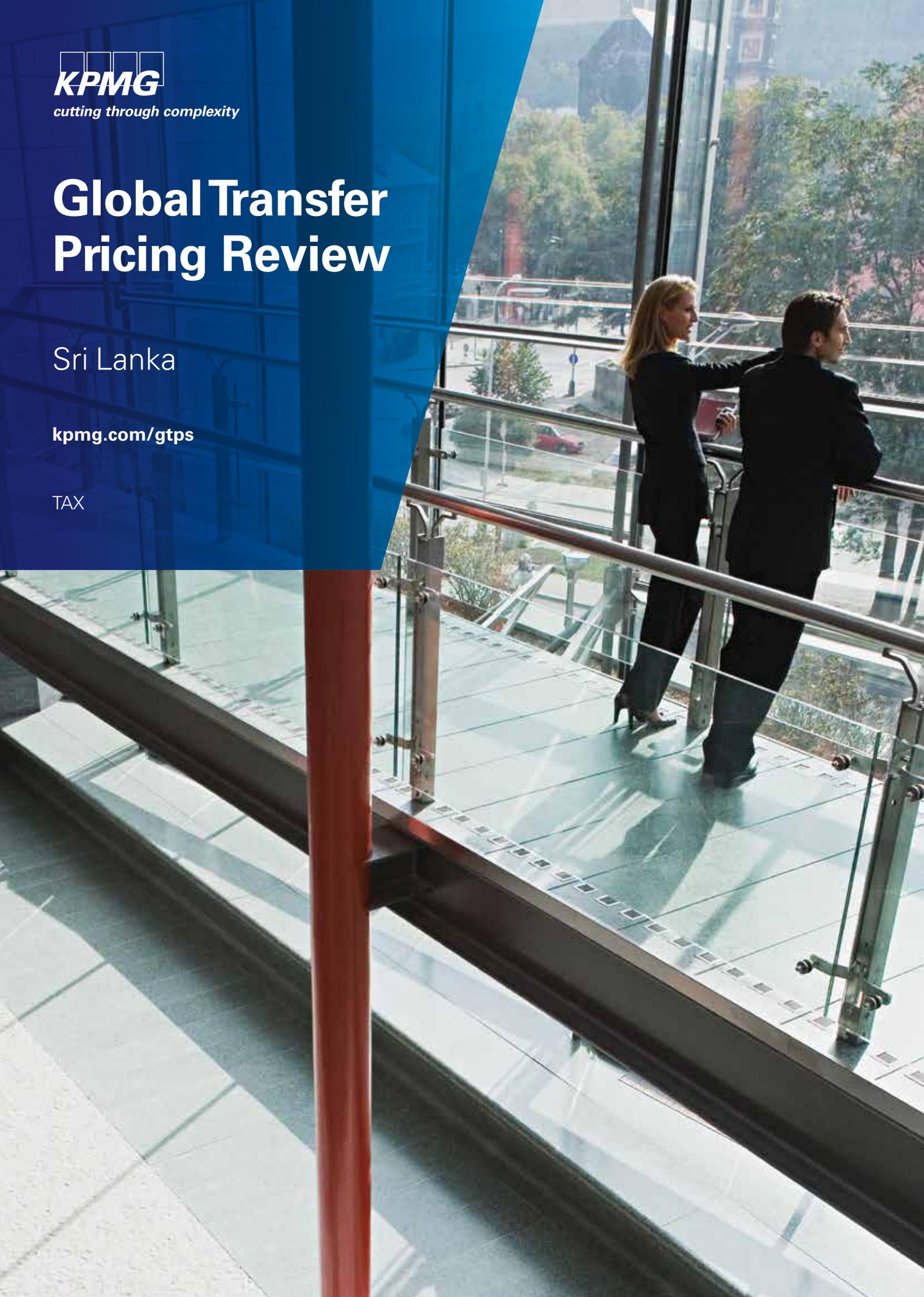
*cutting through complexity*

# Global Transfer Pricing Review

Sri Lanka

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TAX



# Sri Lanka



## KPMG observation

Transfer pricing regulations were introduced into Sri Lanka Income Tax legislation in April 2006. The regulations rely on the arm's length standard as the guiding principle for transactions between 'associated undertakings'. Recently, revised transfer pricing regulations were issued via gazette to address the ambiguities in the previous regulations. The revised regulations supplement the previous ones with administrative guidance on the enforcement of the transfer pricing rules.

Transfer pricing is very new in Sri Lanka, with enforcement only beginning in 2013. Hence, Revenue Authorities have not indicated a position to the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) Action Plan.

## Transfer pricing study snapshot

### The purpose of a transfer pricing study

	Applicable
Legal requirements	●
Protection from penalties	●
Reduce risk of adjustment	●
Shifts burden of proof	●

## Basic information

### Tax authority name

Department of Inland Revenue.

### Citation for transfer pricing rules

Section 104 of the Inland Revenue Act No.10 of 2006 and the Gazette Notification No 1823/5 of 12 August 2013.

### Effective date of transfer pricing rules

Practical enforcement (as per recent IRA circular) — Not confirmed by the IRD yet.

### What is the relationship threshold for transfer pricing rules to apply between parties?

Transfer pricing rules apply to transactions between the taxpayer and an 'associated undertaking', that is where there is a degree of direct or indirect control between the parties. Transfer pricing provisions apply to all transactions regardless of value.

A person is considered to be an associate of the other in the following instances:

- direct or indirect shareholding with not less than 50 percent voting power

- any person directly or indirectly holds not less than 50 percent of the voting power in both undertakings
- loans and advances granted exceed 51 percent of the book value of total assets of the recipient
- guarantees not less than 25 percent of the borrowings of the other undertaking
- more than half of the directors, or one or more executive directors or members of the governing board of one undertaking are appointed by the other undertaking

- more than half of the directors are appointed by the same person or persons
- the manufacture, process, or business is wholly dependent on the input provided by the other undertaking
- 90 percent or more of the raw materials required for manufacture or process is provided directly or by persons specified; and
- a mutual relationship which can be prescribed.

### What is the statute of limitations on assessment of transfer pricing adjustments?

The statute of limitations applicable to income tax applies. Accordingly:

- if return of income has been filed on time: 1.5 years
- if return of income has not been filed on time: four years; and
- where return has not been filed or in the case of fraud, evasion, or wilful default: no time limitation.

## Transfer pricing disclosure overview

### Are disclosures related to transfer pricing required to be submitted to the revenue authority on an annual basis (e.g. with the tax return)?

No. There are no mandated disclosures in tax returns or document to be submitted with the tax return.

It is required that specified documentation be maintained for possible audit for five years to prove arm's length pricing in the event of a revenue assertion.

The revised regulations mandate that the directors certify that transactions concluded with the related parties are at arm's length, and such certification should be included in the annual accounts.

### What types of transfer pricing information must be disclosed?

Not applicable.

### What are the consequences of failure to submit disclosures?

None.

## Transfer pricing study overview

### Can documentation be filed in a language other than the local language? If yes, which ones?

Yes. No formal rules. The generally accepted rule is that documentation can be filed in one of the national languages — Sinhala or Tamil — or in English.

### When a transfer pricing study is prepared, should its content follow Chapter V of the Organisation for Economic Co-operation and Development (OECD) Guidelines?

Yes, for all transactions. Regulations are still to be enforced, but prescribed documentation includes the following:

- a description of the ownership structure of the assessee undertaking
- a profile of the multinational or group of which the assessee undertaking is a part
- 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
- the nature and terms (including prices) of international or group transactions entered into with each associated undertaking
- a description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated undertaking
- a record of the economic and market analysis, 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
- 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 transactions

- a record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant transaction
- 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 selected, and how such method was applied in each case
- a record of the actual work carried out in 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; and
- the assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these rules and consequent adjustments made to the total income for tax purposes.

Availability of supporting documentation in the public domain as prescribed includes:

- official publications, reports, studies and databases from the government of the country of residence of the associated undertaking, or of any other country
- reports of market research studies carried out and technical publications brought out by institutions of national or international repute
- price publications including stock exchange and commodity market quotations
- published accounts and financial statements relating to the business affairs of the associated undertaking
- agreements and contracts entered into with associated undertaking or with unrelated enterprises in respect of transactions similar to that transaction; and

- letters and other correspondence documenting any terms negotiated between the assessee and the associated undertaking documents normally issued in connection with various transactions under the accounting practices followed.

Does the tax authority require an advisor/tax practitioner to have specific designation in order to prepare or submit a transfer pricing study?

No.

## Transfer pricing methods

Does your country follow the transfer pricing methods outlined in Chapter II of the OECD Guidelines? If exceptions apply, please describe.

Yes.

## Transfer pricing audit and penalties

When the tax authority requests a taxpayer's transfer pricing documentation, are there timing requirements for a taxpayer to submit its documentation? And if so, how many days?

No.

When the tax authority requests a taxpayer's transfer pricing documentation, are there timing requirements for a taxpayer to submit its documentation? Please explain.

The law does not prescribe a time frame but requires it to be maintained for five years.

If an adjustment is proposed by the tax authority, what dispute resolution options are available?

The normal appeal procedure available in the Inland Revenue Act would be applicable.

If an adjustment is sustained, can penalties be assessed? If so, what rates are applied and under what conditions?

Yes. The penalty applicable for income tax default would be applicable (i.e. 10 percent for the first month and thereafter two percent for each of the subsequent months).

To what extent are transfer pricing penalties enforced?

To date, revenue investigations into transfer pricing have been limited and carried out under general anti-avoidance provisions in the domestic statute and the Associated Enterprises Article under treaties.

What defenses are available with respect to penalties?

None.

What trends are being observed currently?

Not applicable.

## Special considerations

Are secret comparables used by tax authorities?

It is theoretically possible. However, to date, we have not seen this in practice.

Is there a preference, or requirement, by the tax authorities for local comparables in a benchmarking set?

None to date.

Do tax authorities have requirements or preferences regarding databases for comparables?

No.

Does the tax authority generally focus on the interquartile range in a TNMM analysis?

No.

Does the tax authority have other preferences in benchmarking? If so, please describe.

Regulation prescribes the use of arithmetic mean.

What level of interaction do tax authorities have with customs authorities?

High.

Are there limitations on deductibility of management fees beyond the arm's length principle?

Yes. Deductibility of management fee is limited to 2 million Sri Lankan Rupees (LKR) or one percent of the turnover whichever is lower.

Are management fees subject to withholding?

Yes.

Are there limitations on the deductibility of royalties beyond the arm's length principle?

No.

Are royalties subject to withholding?

Yes.

Are taxpayers allowed to file tax return numbers that differ from book numbers?

No. The current regulations do not provide for this.

Other unique attributes?

Multiple year data permitted for two prior years.

Safe harbor rule exists at three percent. Specifically, the regulation provides for a three percent tolerance level i.e. if the arm's length price is within three percent range from the actual price, no adjustment is required.

## Tax treaty/double tax resolution

What is the extent of the double tax treaty network?

Extensive.

If extensive, is the competent authority effective in obtaining double tax relief?

Sometimes.

When may a taxpayer submit an adjustment to competent authority?

No formal rules exist in this area.

May a taxpayer go to competent authority before paying tax?

Yes, under an Advance Pricing Agreement (APA).

## Advance pricing agreements

What APA options are available, if any?

Unilateral, bilateral.

Is there a filing fee for APAs?

No.

Does the tax authority publish APA data either in the form of an annual report or through the disclosure of data in public forums?

Not applicable.

Are there any difficulties or limitations on the availability or effectiveness of APAs?

Not applicable.

## KPMG in Sri Lanka

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