

Transfer Pricing Law

in Sri Lanka

Over the last two decades the cross border businesses between entities belonging to the same business group have increased considerably due to integration of domestic economy with global economy and growth of multinational enterprises.

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The multinational enterprises and group of companies have been playing a dominant role in international and local trade and business. Various studies made so far indicate that two thirds of the world trade is controlled by multinational groups and trade among them accounts for the bulk of it. Their business activities span from trading of goods and services to undertaking production internationally and locally.

A multinational corporation may have business transactions with its associated enterprises situated in several other countries having similar or different tax systems. The enterprise may transfer goods to its associated enterprises at prices which are not market driven and not comparable with uncontrolled transaction entered between unrelated entities. Same thing could happen in local group companies. This may adversely affect the tax base of a country having higher rate of taxation to the advantage of another country having lower tax rates. In local group companies concern profit of a group can be shifted to a low tax rate or tax exempted associated companies.

The regulations dealing with transfer pricing govern the parameters for determining transfer prices of tangible and intangible property transferred to associated enterprises and incorporate provisions for preventing revenue loss arising from shifting profits from one tax jurisdictions to another or among the group of companies. They deal with allocation of income earned within corporate groups or firms operating in different tax jurisdictions or group of companies in same jurisdictions where tax rates are not uniform. As a result many countries have been introducing anti-avoidance legislation to counteract tax avoidance by over or under pricing of goods and services.

The issues concerning transfer pricing are of importance to all countries, because of their impact on tax revenues and importance in the economic activities. When enterprises of a group have business activities in different countries, they can determine the level of taxation in a particular country by adjusting the price mechanism. They can combine the available resources and save on interest, other costs and research and development expenses etc. They can also employ methods to minimise their tax liability; by shifting their profit base, from high to low tax jurisdictions or associated company in the same jurisdiction which pays low tax rates or enjoying tax holidays or exemption. As these enterprises generate substantial taxable income outside their home country, they are concerned of prevailing transfer pricing regulations.

RATIONALE OF REGULATIONS

Every country wants to preserve its right to tax the profits that can reasonably be considered to arise within its territory. The transfer pricing legislation tries to address this issue and incorporates

provisions which provide a fair basis of computing arm's length prices. Section 103, 104, 26(w), (x), 27 of Inland Revenue amended Act No. 10 of 2006 has basically formulated to address this issues. The rationale of provisions in this regard in countries having international transactions and group of companies are discussed below:

1. The regulations provide a statutory framework, which can lead to computation of reasonable, fair and equitable profits and tax in different jurisdictions and among entities in the group of companies.

2. It protects the high of a country to collect fair share of tax in respect of cross border transactions between related entities. Thus it ensures that revenue of countries involved is protected and incomes of the multinational enterprises are apportioned fairly between the countries involved.

3. The absence of regulations allows multinational enterprises and group of companies to shift profits to low tax entities by manipulating prices of intra group transactions.

TRANSFER PRICING CONCEPT

The Organisation of Economic Cooperation and Development defines transfer pricing as "prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises."

Simply stated it means determination of price of goods, services and intangibles transacted between associated enterprises that belong to the same business group. It therefore refers to prices charged by an associated enterprise of a group for transfer of goods and services provided to another enterprise of the same group.

The transfer prices are generally set within a group as against market prices set in transactions between independent enterprises. It affects every aspect of operations of multinational as well as group enterprise such as manufacturing, marketing, distribution, research and development, and after sales services etc. The concept is commonly used in international transactions though similar transactions may take place in domestic markets.

TRANSFER PRICING SYSTEM

An efficient transfer pricing system is the one that provides a reasonable method for allocating revenue to the concerned taxation jurisdictions as well as among the group of companies apart from providing a simple and consistent tax regime to tax payers. The principle underlying the transfer pricing legislation should be internationally acceptable and the cost of administering the regulations should relatively be low. Besides the compliance costs for the taxpayers should be reasonable.

The law should ensure certainty and simplicity in application of provisions and avoid any ambiguity in legal provisions and methods for determining arm's length price. The prescribed methods should be internationally acceptable and easy to understand and apply. (Prescribed methods and guidelines have not yet been given by the Inland Revenue) This is because any uncertainty in legislation may give rise to litigation, which in turn may add to the cost to taxpayers and also adversely affect the limited resource of tax administration.

At times it may not be easy to find a comparable transaction and there may be no arm's length price with which the price charged by the multinational enterprise or group of companies can be compared. Therefore, difficulties in this regard should be given due consideration in application of arm's length rule.

It is equally important that the system given due recognition to rules regarding burden of proof, documentation, examination practices, penalties and dispute resolution mechanism. The revenue should also appreciate the practical difficulties in applying the arm's length principle and avoid narrow interpretation of the law.

The transfer pricing regulations empower tax administration to determine arm's length price and adjust profits between two enterprises only when parties to the transactions are associated enterprises.

The two enterprises are considered to be associated if there is common management, common ownership, or control of one enterprise over the other. The expression management and control is used in relation to affairs of business and not business as such. The Control and management means de facto control and management and not merely the right or power to control and manage the affairs of a company. Thus control and management signifies the controlling and directive power, the head and brain of the enterprise. A common way in which the persons or entities may become associated is through acquiring stock ownership or exercising "effective control" over other by having contractual and other arrangements between these entities.

The concept of associated enterprise exists in tax laws of all the countries where transfer-pricing regulations are in force though based upon peculiar conditions the definition is either exhaustive or restrictive. E.g.: Indian transfer pricing law says if one enterprise gives guarantee to another enterprise not less than 10% of the total borrowing of the other also should be treated as an associated enterprise for the purpose of transfer pricing

The basic conditions necessary to invoke transfer-pricing regulations are that the transaction should be between two associated enterprises. Generally it is difficult to analyse such transactions because of complicated nature of these agreements each of which might effect the control over and the income derived from one or more of the numerous entities involved in the system. The countries like USA do not make any distinction between domestic and international transactions and therefore, these regulations apply to both type of transaction. Sri Lanka tax law also has formulated in this basis. However, the position is different in India as domestic transactions are outside the ambit of the transfer pricing legislation. Thus associated enterprises operating within the country are not affected by these provisions.

Multinational companies and group of companies generally reduce their tax liabilities, inter alias, through the following practices.

- (a) *Collusive invoicing*
- (b) *Use of tax haven countries*
- (c) *Inflation of expenses such as interest, rent etc.*
- (d) *Showing payment for non-existent services*
- (e) *Shifting the sources of income*
- (f) *Manipulating prices and*
- (g) *Inflating head office expenses etc.*

Amendments to the Inland Revenue Act have still not been interpreted in required areas. We hope that the relevant guide lines will be issued soon.

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