

STUDY TEXT



CA SRI LANKA CURRICULUM 2020

Business Level II BL 7 Business Taxation

First edition 2019

ISBN 978-955-3983-36-7

National Library and Documentation Services Board

Published by

The Institute of Chartered Accountants of Sri Lanka
30A, Malalasekera Mawatha
Colombo 7.

www.casrilanka.com

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2019

Introduction

Business Level II – Business Taxation

As a core competency, a knowledge of taxation is developed in a progressive manner to ensure a specialization in the subject. The work performed at this level is limited to basic computations of taxes, payments and filing returns under supervision. Exposure is also given on the computation of profits of a sole proprietor or partnership business and other taxes in a non- complex scenario.

Syllabus structure

Main Topics/Syllabus area		Weighting
1	Introduction to Taxation	5%
2	Income Tax Liability of a Resident Individual	25%
3	Basic Income Tax liability of a Resident Company	10%
4	Gains from realisation of investment assets	5%
5	Value Added Tax	15%
6	Other taxes applicable to businesses	10%
7	Basic Income Tax Administration and Income Tax Payment Procedure	20%
8	Taxation of Other persons & entities	10%
Total		100

One of the key elements in examination success is practice. It is important not only that you fully understand the topics by carefully reading the information contained in this Study Text, but it is also vital that you practise the techniques and apply the principles that you have learned.

In order to do this, you should:

- Work through all the examples provided within the chapters and review the solutions, ensuring that you understand them;
- Complete the progress test for each chapter.

In addition, you should use the Revision Kit. These questions will provide you with excellent examination practice when you are in the revision phase of your studies.

Pillar Structure

The Chartered Accountant Curriculum is structured around four progressively ascending levels of competency, namely, Business I, Business II, Corporate and Strategic Levels.

Business Level II provides the fundamentals of accounting and harnesses the skills and professional values needed to mould a Certified Business Accountant.

The Curriculum is also subdivided into specific subject areas or knowledge pillars and learning material is delivered to meet the knowledge requirements. These **Knowledge Pillars** focus on imparting the technical knowledge required of a competent CA and comprise of five pillars that focus on the following subject areas:

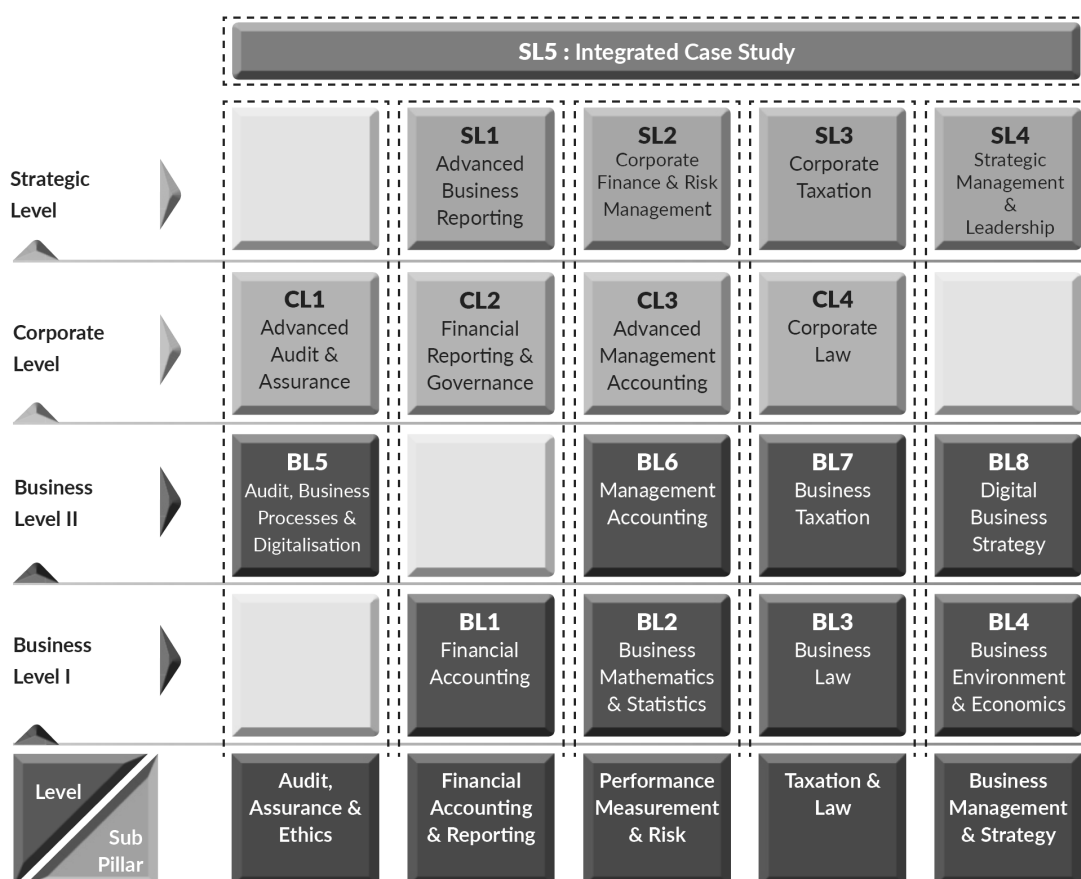
Knowledge Pillar 1: Audit, Assurance & Ethics (AA&E)

Knowledge Pillar 2: Financial Accounting & Reporting (FAR)

Knowledge Pillar 3: Performance Measurement & Risk (PM&R)

Knowledge Pillar 4: Taxation & Law (T&L)

Knowledge Pillar 5: Business Management & Strategy (BM&S)



Chapter features

Each chapter contains a number of helpful features to guide you through each topic.

Topic list	This tells you what you will be studying in the chapter. The topic items form the numbered headings within the chapter.
Chapter introduction	The introduction puts the chapter topic into perspective and explains why it is important, both within your studies and within your practical working life.
Learning outcomes	The learning outcomes issued for the module by CA Sri Lanka are listed at the beginning of the chapter, with reference to the chapter section within which coverage will be found.



Key terms

These are definitions of important concepts that you really need to know and understand before the exam.



Examples

These are illustrations of particular techniques or concepts with a worked solution or explanation provided immediately afterwards.



Case study

Often based on real world scenarios and contemporary issues, these examples or illustrations are designed to enrich your understanding of a topic and add practical emphasis.



Questions

These are questions that enable you to practise a technique or test your understanding. You will find the answer underneath the question.



Formula to learn

These are the formula that you are required to learn for the exam.



Section introduction

This summarises the key points to remember from each section.



Chapter roundup

This provides a recap of the key areas covered in the chapter.



Progress Test

Progress tests at the end of each chapter are designed to test your memory.

Bold text

Throughout the Study Text you will see that some of the text is in bold type. This is to add emphasis and to help you to grasp the key elements within a sentence or paragraph.

Learning outcomes

CA Sri Lanka's learning outcomes for the Module are set out on the following pages. They are cross-referenced to the chapter in the Study Text where they are covered.

1. Introduction to Taxation Syllabus Weighting: 5%		
Knowledge Component	Learning Outcome	Specific Knowledge
1.1. Functions and principles of taxation	1.1.1 State the economic and social functions of taxation. 1.1.2 State the principles of taxation and the difference between direct taxes and indirect taxes.	Economic and social functions of taxation . Principles of taxation and the difference between direct taxes and indirect taxes .
1.2. Tax system in Sri Lanka	1.2.1 State the role of the following tax authorities in Sri Lanka: Lanka: – Department of Inland Revenue – Provincial Departments of Revenue – Department of Customs and Excise Department 1.2.2 Identify the following major taxes in Sri Lanka: – Income Tax – Value-Added Tax (VAT) – Nation Building Tax (NBT) – Economic Service Charge – Stamp Duty – Excise Duty and Taxes on Imports	Roles of the following tax authorities in Sri Lanka: – Department of Inland Revenue – Provincial Departments of Revenue – Department of Customs and Excise Department Major taxes in Sri Lanka: – Income Tax – Value-Added Tax (VAT) – Nation Building Tax (NBT) – Economic Service Charge – Stamp Duty – Excise Duty and Taxes on Imports

2: Income Tax Liability of a Resident Individual

Syllabus Weighting: 25%

Knowledge Component	Learning Outcome	Specific Knowledge
2.1 Imposition of income tax	2.1.1 Identify the Statutory provisions applicable to income tax. 2.1.2 Explain the chargeability of income tax to a person under the Inland Revenue Act. 2.1.3 Explain the changeability of income tax to a person under the Inland Revenue Act	Statutory provisions applicable to income tax Chargeability of income tax to a person under the Inland Revenue Act Meaning of “person”, year of assessment, source of income & income and the “residence rule”.
2.2 Statutory income from sources of income & income listed in the Inland Revenue Act	2.2.1 Calculate assessable income from a business of small or medium scale enterprise taking into consideration allowable and disallowable expenses and realisation of capital assets. 2.2.2 Calculate Assessable income from employment (including all cash and non-cash benefits). 2.2.3 Calculate assessable income from investment (excluding gains from realisation of investment assets in chapter 4).	Assessable income from a business of small or medium scale enterprise taking into consideration allowable and disallowable expenses and realisation of capital assets . Assessable income from employment (including all cash and non-cash benefits). assessable income from investment (excluding gains from realisation of investment assets in chapter 4) .
2.3 Taxable income	2.3.1 Calculate the taxable income taking into consideration the relevant qualifying payments and reliefs.	Taxable income taking into consideration the relevant qualifying payments and reliefs .

3: Basic Income Tax liability of a Resident Company

Syllabus Weighting: 10%

Knowledge Component	Learning Outcome	Specific Knowledge
<p>3.1 Basic understanding of income tax liability of a resident company (non-complex straightforward scenario)</p>	<p>3.1.1 Identify various types of companies in relation to application of different rates of income tax. 3.1.2 Explain specific adjustments applicable to the computation of Assessable income of a company from business (other than adjustments applicable to intercompany transactions). 3.1.3 Compute taxable income of a company, by making relevant statutory deductions. 3.1.4 Compute income tax payable by a small or medium sized company.</p>	<p>Various types of companies in relation to application of different rates of income tax. Specific adjustments applicable to the computation of Assessable income of a company from business (other than adjustments applicable to intercompany transactions). Taxable income of a company, by making relevant statutory deductions. Income tax payable by a small or medium sized company.</p>
<p>3.2 Basic Transfer Pricing</p>	<p>3.2.1 Identify the concept of arm's length price. 3.2.2 State documentation requirements under transfer pricing regulations.</p>	<p>The concept of arm's length price . Documentation requirements under transfer pricing regulations .</p>

4: Gains from realisation of investment assets

Syllabus Weighting: 5%

Knowledge Component	Learning Outcome	Specific Knowledge
4.1 Imposition of tax on gains from realization of assets & liabilities	<p>4.1.1 Identify the history of capital gains tax in Sri Lanka.</p> <p>4.1.2 State the consequences of non-compliance.</p> <p>4.1.3 Identify investments assets.</p>	<p>The history of capital gains tax in Sri Lanka.</p> <p>Consequences of non-compliance.</p> <p>Investments assets .</p>
4.2 Cost of an asset and consideration	<p>4.2.1 Identify cost of an asset and incidental expenditure.</p> <p>4.2.2 Identify the consideration received on realization of asset .</p>	<p>Cost of an asset and incidental expenditure.</p> <p>The consideration received on realization of asset .</p>
4.3 Realization of assets and liabilities	<p>4.3.1. State points of realization of assets and liabilities including reversal, refunds and compensation.</p> <p>4.3.2. Identify realization with retention of assets</p> <p>4.3.3. Identify transfer of assets to spouse and former spouse, transfer on death, transfer to an associate for no consideration.</p> <p>4.3.4. Identify involuntary realization with replacement .</p> <p>4.3.5. Identify involuntary realization by separation .</p>	<p>Points of realization of assets and liabilities including reversal, refunds and compensation</p> <p>Realization with retention of assets</p> <p>Transfer of assets to spouse and former spouse, transfer on death, transfer to an associate for no consideration</p> <p>Involuntary realization with replacement</p> <p>Involuntary realization by separation</p>
4.4 Calculation of gains & losses	<p>4.4.1 Calculate the gain or loss from realisation of assets & liabilities.</p> <p>4.4.2 Explain the procedure for the payment of tax on realisation of gains.</p>	<p>Gain or loss from realisation of assets & liabilities.</p> <p>Procedure for the payment of tax on realisation of gains .</p>

5: Value Added Tax (VAT)

Syllabus Weighting: 10%

Knowledge Component	Learning Outcome	Specific Knowledge
5.1 Obligations of a VAT-registered person	<p>5.1.1 imposition of value added tax along with the definitions for the terms “taxable activity”, “taxable supply”, “supply of goods”, “supply of services”, “time of supply”, “taxable period” and the “registered person” .</p> <p>5.1.2 Advise the statutory obligations with regard to furnishing returns, payment of tax and documentation.</p> <p>5.1.3 Assess the output tax, input tax and balance tax payable by a registered person in business which carries out multiple activities”.</p>	<p>Imposition of value added tax along with the definitions for the terms “taxable activity”, “taxable supply”, “supply of goods”, “supply of services”, “time of supply”, “taxable period” and the “registered person” .</p> <p>Statutory obligations with regard to furnishing returns, payment of tax and documentation.</p> <p>Output tax, input tax and balance tax payable by registered person in business which carries out multiple activities”.</p>
5.2 Simplified VAT Scheme	<p>5.2.1 Assess the VAT liability of a registered identified purchaser and registered identified supplier.</p> <p>5.2.2 Outline the significant features of the Simplified VAT Scheme.</p>	<p>VAT liability of a registered identified purchaser and registered identified supplier.</p> <p>Significant features of the Simplified VAT Scheme.</p>
5.3 Managing VAT in a business	<p>5.3.1 Explain statutory provisions of the VAT Act with regard to assessments, time-bar for assessments, appeals and appeal settlement procedure.</p> <p>5.3.2 Analyse VAT issues in a complex business environment and provide appropriate actions to mitigate such situations.</p>	<p>Statutory provisions of the VAT Act with regard to assessments, time-bar for assessments, appeals and appeal settlement procedure.</p> <p>VAT issues in a complex business environment and provide appropriate actions to mitigate such situations.</p>

6: Other taxes applicable to businesses

Syllabus Weighting: 10%

Knowledge Component	Learning Outcome	Specific Knowledge
6.1 Nation Building Tax (NBT)	<p>6.1.1 Explain the applicability of NBT to small- and medium-sized businesses, and the registration threshold.</p> <p>6.1.2 List a few excepted articles and services.</p> <p>6.1.3 Compute tax payable in a straightforward, non-complex scenario.</p> <p>6.1.4 Explain the due dates of payment and submission of returns.</p>	<p>Applicability of NBT to small- and medium-sized businesses, and the registration threshold.</p> <p>Excepted articles and services.</p> <p>Tax payable in a straightforward, non-complex scenario.</p> <p>Due dates of payment and submission of returns.</p>
6.2 Economic Service Charge (ESC)	<p>6.2.1 Explain the applicability of ESC to small- and medium-sized businesses, and the registration threshold.</p> <p>6.2.2 Compute tax payable in a straightforward, non-complex scenario and submission of return</p> <p>6.2.3 Explain the due dates of payment</p>	<p>Applicability of ESC to small- and medium-sized businesses, and the registration threshold.</p> <p>Tax payable in a straightforward, non-complex scenario.</p> <p>Due dates of payment and submission of returns.</p>
6.3 Stamp duty	<p>6.3.1 Explain stamp duty payable to Provincial Councils on immovable properties and calculate stamp duty on sale & gift of properties.</p> <p>6.3.2 Explain stamp duty payable to Central Government on specified instruments and calculate stamp duty based on given rates.</p>	<p>Stamp duty payable to Provincial Councils on immovable properties and calculate stamp duty on sale & gift of properties .</p> <p>Stamp duty payable to Central Government on specified instruments and calculate stamp duty based on given rates.</p>

7: Basic Income Tax Administration and Income Tax Payment Procedure

Syllabus Weighting: 20%

Knowledge Component	Learning Outcome	Specific Knowledge
7.1 Return of income	7.1.1 State the circumstances under which an individual or a company is required to furnish a “return” with due dates. 7.1.2 State the consequences of non-compliance.	Circumstances under which an individual or a company is required to furnish a “return” with due dates. Consequences of non-compliance.
7.2 Assessments	7.2.1 Identify Self assessments, default assessments, and advance assessments, amended or additional assessments and circumstances leading to such assessments. 7.2.2 Identify time bar periods applicable for each types of Assessments.	Self assessments, default assessments, and advance assessments, amended or additional assessments and circumstances leading to such assessments. Time bar periods applicable for each types of Assessments.
7.3 Objections & Appeals	7.3.1 State requirements and procedure for an Administrative Review. 7.3.2 Explain the procedure for appeal to the Tax Appeals Commission (TAC). 7.3.3 Explain the circumstances for appeals from TAC .	Requirements and procedure for an Administrative Review. Procedure for appeal to the Tax Appeals Commission (TAC). Circumstances for appeals from TAC .
7.4 Payment of tax and recovery of tax in default	7.4.1 Explain the liability to settle income tax on a “self-assessment” basis, including due dates and calculate tax payable by instalments . 7.4.2 Explain penalties applicable on the non/late payment of tax. 7.4.3 List recovery actions available under the Inland Revenue Act	Liability to settle income tax on a “self-assessment” basis, including due dates and calculate tax payable by instalment Penalties applicable on the non/late payment of tax. Recovery actions available under the Inland Revenue Act.
7.5 Withholding by Employers	7.5.1 Explain characteristics of Pay As You Earn (PAYE) system. 7.5.2 Explain the obligations of an employer under PAYE.	Characteristics of Pay As You Earn (PAYE) system. Obligations of an employer under PAYE.

7.6 Withholding from investment returns	<p>7.6.1 Identify payments subjected to WHT and relevant rates .</p> <p>7.6.2 Explain withholding tax applicable for partnership .</p> <p>7.6.3 Identify exemptions from withholding tax .</p>	Payments subjected to WHT and relevant rates. Withholding tax applicable for partnership. Exemptions from withholding tax .
7.7 Withholding from service fees and contract Payments.	<p>7.7.1 Identify payments subjected to WHT and relevant rates .</p> <p>7.7.2 Identify exemptions from withholding tax</p>	Payments subjected to WHT and relevant rates. Exemptions from withholding tax .
7.8 Other matters relevant to withholding tax	<p>7.8.1 Explain compliance requirements under WHT system.</p> <p>7.8.2 Identify Final withholding payments.</p> <p>7.8.3 Explain tax credits for non-final withholding tax paid.</p>	Compliance requirements under WHT system Final withholding payments. Tax credits for non-final withholding tax paid .

8. Taxation other Persons & Entities Syllabus Weighting: 10%		
Knowledge Component	Learning Outcome	Specific Knowledge
8.1 Bodies of persons	<p>8.1.1 State the interpretations of the following terms for tax purposes: “body of persons, charitable purpose and charitable institution” .</p> <p>8.1.2 Explain the chargeability of income tax from charitable institutions and non-governmental organisations.</p> <p>8.1.3 Assess the tax liability of a charitable institution and non-governmental organisation.</p> <p>8.1.4 Calculate the taxable income of a partnership, tax payable by a partnership, distribution of partnership income among partners and taxation of individual partners .</p>	<p>Interpretations of the following terms for tax purposes: “body of persons, charitable purpose and charitable institution” .</p> <p>Chargeability of income tax from charitable institutions and non-governmental organisations.</p> <p>Tax liability of a charitable institution and non-governmental organisation.</p> <p>Taxable income of a partnership, tax payable by a partnership, distribution of partnership income among partners and taxation of individual partners .</p>
8.2 Trustees, executors and receivers	<p>8.2.1 Explain the meaning of the terms executor, trustee and receiver.</p> <p>8.2.2 Assess income tax liability of a person in the above capacities.</p>	<p>Meaning of the terms executor, trustee and receiver.</p> <p>Income tax liability of a person in the above capacities.</p>

Action verbs checklist

Knowledge Process	Verb List	Verb Definitions
Tier - 1 Remember Recall important information	Define	Describe exactly the nature, scope or meaning
	Draw	Produce (a picture or diagram)
	Identify	Recognise, establish or select after consideration
	List	Write the connected items one below the other
	Relate	To establish logical or causal connections
	State	Express something definitely or clearly
Tier - 2 Comprehension Explain important information	Calculate/Compute	Make a mathematical computation
	Discuss	Examine in detail by argument showing different aspects, for the purpose of arriving at a conclusion
	Explain	Make a clear description in detail revealing relevant facts
	Interpret	Present in understandable terms or to translate
	Recognise	To show validity or otherwise, using knowledge or contextual experience
	Record	Enter relevant entries in detail
	Summarise	Give a brief statement of the main points (in facts or figures)
	Classify	Allocate into categories
	Describe	Communicate the key features
	Provide	Give illustrations to support or illuminate a point or assertion
Tier - 3 Application Use knowledge in a setting other than the one in which it was learned/solve close-ended problems	Apply	Put to practical use
	Assess	Determine the value, nature, ability or quality
	Demonstrate	Prove, especially with examples
	Graph	Represent by means of a graph
	Prepare	Make ready for a particular purpose
	Prioritise	Arrange or do in order of importance
	Reconcile	Make consistent with another
	Solve	To find a solution through calculations and/or explanations

Knowledge Process	Verb List	Verb Definitions
	Conduct	Organize and carry out a task
	Communicate	Transmit thoughts or knowledge
	Display	Make evident or noticeable
	Perform	Do or execute, usually in the sense of a complex procedure
	Reconcile	Make or prove consistent or compatible or show differences
	Set	Fix or establish
	Select	Choose from a range of options or possibilities
	Support	Assist to make decisions by providing appropriate information about respective concepts
	Use	Apply in a practical way
	Undertake	Commit to do or perform
Tier - 4 Analysis Draw relations among ideas and to compare and contrast/solve open-ended problems	Analyse	Examine in detail in order to determine the solution or outcome
	Compare	Examine for the purpose of discovering similarities
	Contrast	Examine in order to show unlikeness or differences
	Construct	Build or make a diagram, model or formula
	Differentiate	Constitute a difference that distinguishes something
	Outline	Make a summary of significant features
	Write	Provide word descriptions to express an opinion or idea
Tier - 5 Evaluate Formation of judgments and decisions about the value of methods, ideas, people or products	Advise	Offer suggestions about the best course of action in a manner suited to the recipient
	Convince	To persuade others to believe something using evidence and/or argument
	Criticise	Form and express a judgment
	Comment	Provide written remarks expressing an opinion in both positive and negative perspectives
	Evaluate	To determine the significance by careful appraisal
	Conclude	Form a judgment about, or determine or resolve the outcome of, an issue through a process involving reasoning
	Determine	Ascertain or conclude after analysis and consideration; judge

Knowledge Process	Verb List	Verb Definitions
	Justify	Give valid reasons or evidence for
	Review	Study critically with a view to correction or improvement
	Recommend	A suggestion or proposal as to the best course of action
	Resolve	Settle or find a solution to a problem or contentious matter
	Validate	Check or prove the accuracy
Tier - 6 Synthesis Solve unfamiliar problems by combining different aspects to form a unique or novel solution	Compile	Produce by assembling information collected from various sources
	Design	Devise the form or structure according to a plan
	Develop	To disclose, discover, perfect or unfold a plan or idea
	Propose	To form or declare a plan or intention for consideration or adoption
	Anticipate	Foresee, or experience or realise beforehand
	Draft	Write original material for the scrutiny of others
	Formulate	Devise and put into words
	Plan	Devise the plan for an assurance engagement
	Report	Give the formal final conclusion for an assurance engagement
	Submit	Send a completed document to a particular party
	Suggest	Put forward an idea or give reasons
	Synthesize	Make or propose a new concepts or ideas by combining existing knowledge in different aspects



Business Taxation

Introduction to Taxation

INTRODUCTION

In this lesson you will learn the functions of taxation together with principles of taxation. Furthermore, Sri Lankan tax system including major taxes and respective collecting authorities are described in this chapter.

Knowledge Component

A. Introduction to Taxation

1.1 Functions and principles of taxation	1.1.1	State the economic and social functions of taxation.
	1.1.2	State the principles of taxation and the difference between direct and indirect taxes.
1.2 Tax system in Sri Lanka	1.2.1	State the role of the tax authorities in Sri Lanka (Department of Inland Revenue, Provincial Departments of Revenue, Department of Customs and Excise Department).
	1.2.2	Identify the major taxes in Sri Lanka (Income Tax, Value Added Tax (VAT), Nation Building Tax, Economic Service Charge, Stamp Duty, Excise Duty and Taxes on Imports).

CHAPTER CONTENTS	LEARNING OUTCOME
1 Introduction to taxation	N/A
2 Functions and principles of taxation	1.1.1, 1.1.2
3 Current tax system in Sri Lanka	1.2.1, 1.2.2

1. Introduction to taxation

What is taxation?

A tax is a compulsory payment or contribution made by the citizen of a country to the government for the benefit of the country. The Government collects revenue in the form of taxes, charges, levies, fines, etc.

In taxation, taxes are imposed in two forms as direct tax and indirect tax. A **direct tax** is levied directly on personal or corporate income whereas an **indirect tax** is levied on the price of a good or a service.

2. Functions and principles of taxation



Functions of taxation can be mainly separated into **primary function, economic function and social function.**

2.1 Primary function of taxation

Raising funds for public expenditure is the primary function of taxation.



Public expenditure: In Sri Lanka there are number of services provided by the State at free of charge or at subsidized rates for its citizens.



Example: Services provided by the State

- Security, law and order provided by armed forces and police
- Free education provided by government schools and universities
- Free medical services provided by government hospitals
- Maintenance of road network
- Supply of electricity/water at subsidized rates

It should not be necessarily mentioned that the State is required to incur expenditure such as salaries, wages, investments in capital assets, etc. in providing such services to its citizens. The State is required to collect funds to finance such public expenditure.

Thus, raising funds for public expenditure is the primary function of taxation.



QUESTION

Primary function of taxation

State the primary function of taxation.

ANSWER

Raising funds for public expenditure is the primary function of taxation.

2.2 Social and economic functions of taxation

Social and economic functions of taxation are as follows:

Economic functions of taxation:

- **Set local and foreign investment direction** – The State could encourage or discourage private sector investments by using taxation tools such as rates and incentives.
- **Protect local industries from foreign competition** – Vital local industries could be protected from foreign competition via tools such as import taxes.

Social functions of taxation:

- **Discourage activities which are undesirable by the society** - Tax tools could be used to curb undesirable activities such as consumption of liquor & tobacco or gaming & gambling.
- **Encourage activities which are desirable by the society** - Desirable activities such as savings, retirement investments, innovation, research & development, etc. could be encouraged via taxation system.
- **Reduce income disparity between rich and poor** – Income inequality in the society could be reduced via taxation system using progressive tax rates, rebates, etc.



QUESTION

Economic and social functions of taxation

Identify economic and social functions of taxation.

ANSWER

Economic functions:

- Set local and foreign investment direction
- Protect local industries from foreign competition

Social functions:

- Discourage activities which are undesirable by the society
- Encourage activities which are desirable by the society
- Reduce income disparity between rich and poor

2.3 Principles of taxation



Designing and implementation of tax system is based on number of principles.



Principles of taxation: Principles on which the State should be guided by designing and implementing a tax system are considered as principles of taxation.

Principles of taxation include:

- **Equity:** Tax burden should be equal among persons in similar economic circumstances. As Adam Smith put it forward “the subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities”. The following are the two equity principles:
 - i. Benefit principle
 - ii. Ability to pay principle

The **benefit principle** arises from the need that the greatest beneficiaries should make the greatest tax contribution. In this case identification of the received benefit is complicated. Therefore **ability to pay principle** forms a better alternative for equity in taxation. Accordingly ability to pay principle can be categorized in to two scenarios. i.e., horizontal equity and vertical equity.

Horizontal equity implies that we give the same treatment to people in an identical situation. For example, if two people earn Rs. 1 million per month, they should pay the same amount of tax.

Vertical equity means the people with higher income should pay more taxes. Vertical equity seeks to tax in a progressive way (i.e., people with higher ability to pay should pay more tax to the Government).

- **Certainty:** Tax should be certain as uncertainty will lead to tax evasion. The time of payment, the manner of payment, the quantity to be paid ought all to be clear and plain to the taxpayer and to every other person. A successful function of an economy requires that the people, especially the business class, must be certain about the sum of tax that they have to pay on their income from work or investments.
- **Convenience and voluntary compliance:** Tax should be implemented conveniently to taxpayers while encouraging voluntary compliance. For example, income tax is collected on instalment basis.
- **Economy:** The Government should collect taxes with a minimum collection cost. If the tax system is complicated, elaborated administrative machinery should be employed to collect taxes and consequently collection costs will be relatively larger. In order to achieve “economy” in the tax collection, the taxes should be as simple as possible.
- **Progressivity:** Tax burden should be proportionate to taxpayer’s income level and ability to pay. This links with the concept of vertical equity and ability to pay principle. The ultimate expectation of this principle is to ensure that people with higher income pay more taxes than people with lower income.
- **Efficiency:** A tax is said to be efficient when the cost of collecting tax is lower compared with collected tax revenue.
- **Adequacy:** Tax collection should be sufficient to cover expected portion of public expenditure.
- **Broad base:** Tax system should be wide enough to include various sectors in the society and population whereby minimizing individual tax burden.
- **Simplicity:** An average taxpayer should be able to understand the imposition, assessment and payment of tax.

Note: It should be noted that all the taxes imposed may not have all the desired principles mentioned above. Everyone is required to comply with tax regulations once enacted even if they are inconsistent with any of the principles.



QUESTION

Principles of taxation

State four principles of taxation.

ANSWER

- Equity
- Progressivity
- Simplicity
- Certainty

2.4 Direct and indirect taxes



Taxes can be broadly classified into direct and indirect taxes.

Difference between direct tax and indirect tax

	Direct tax	Indirect tax
Imposition of payment	Direct taxes should be paid by taxpayer directly to the Government	Indirect taxes are collected by a person other than the person on whom the tax is imposed
Shifting of tax burden	Tax burden cannot be shifted	Tax burden can be shifted to the final consumer
Collection	Collection cost is high unless there is voluntary compliance	Low collection cost
Tax burden	generally direct taxes are progressive	Indirect taxes have regressive impact
Example	Income tax	VAT and NBT

3. Current tax system in Sri Lanka

3.1 Tax authorities in Sri Lanka



Current tax system in Sri Lanka is administered by number of Government Departments such as Department of Inland Revenue, Provincial Departments of Revenue, Department of Customs, Department of Excise, etc.

Department of Inland Revenue (DIR)

DIR has been designated as the Administrative Authority for various taxes imposed via Parliamentary Acts. The role of DIR is captured in the Mission Statement of the Department:

“To collect taxes in-terms of relevant tax and other related laws, by encouraging voluntary compliance while deterring tax evasion and tax avoidance, and to enhance public confidence in the tax system administered by the Department of Inland Revenue by the minister in relevant tax and other related laws in a fair, friendly and expeditious manner and thereby facilitate a beneficial tax culture”.

The main taxes administered by the DIR are:

- Income Tax(IT)
- Value Added Tax(VAT)
- Nations Building Tax(NBT)
- Stamp Duty under Stamp Duty (Special Provisions) Act
- Economic Service Charge(ESC)
- Construction Industry Guarantee Fund Levy (CIGFL). According to the 2016 budget proposal, CIGFL removed with effect from 1 January 2016.

Provincial Departments of Revenue

Provincial Councils were established under the 13th amendment to the Constitution and Provincial Departments of Revenue entrusted with certain revenue collection within respective provinces. Currently following taxes and charges are collected by Provincial Departments of Revenue under Provincial Statutes:

- Stamp Duty
- Mineral Tax
- Drug & Chemical Tax
- Lottery Tax
- Prize Competition Tax
- Betting Tax

**** Turnover Tax (TT)** was administered by Provincial Departments of Revenue till its abolishment on 31 December 2010.

Department of Customs

Sri Lanka Customs is responsible for collection of taxes on imports and exports. Furthermore, the Department of Customs is playing a major role in controlling and monitoring imports and exports of restricted and prohibited goods of environmental, health, social and security concerned.

Department of Excise

Department of Excise is entrusted with efficient and effective administration of the Liquor and Tobacco industry in Sri Lanka through the collection of revenue and prevention of illicit manufacture and sale of such products, for development and welfare of the society, and the enforcement of the Poisons, Opium and Dangerous Drugs Ordinance for the social protection of Sri Lanka.

3.2 Major taxes in Sri Lanka

The following are the major taxes:

- **Income Tax** - Income is a direct tax levied on income of every person. **The Commissioner General of Inland Revenue** is empowered to collect income tax.
- **Value Added Tax (VAT)** - VAT is the main indirect tax levied to final consumers of products and services and it is administrated by the **Commissioner General of Inland Revenue**. However, it is collected at the point of importation or from the manufacturers and traders based on their value addition with the view to avoid the cascading effect (tax on tax).
- **Nation Building Tax (NBT)** - NBT is another tax which is imposed on turnover in Sri Lanka with effect from 1 February 2009 and handled by the **Commissioner General of Inland Revenue**.
- **Economic Service Charge (ESC)** - ESC is a direct tax which levied on business turnover of every person or a partnership administrated by the **Commissioner General of Inland Revenue**.
- **Import Duties** - Import duties are levied at various rates on importation of goods in to the country and the **Director General of Customs** is responsible for administrating import taxes.

- **Stamp Duty** – Stamp duty is charged on every “specified instrument”:
 - a) executed, drawn or presented in Sri Lanka; or
 - b) executed outside Sri Lanka being an instrument which relates to property situated in Sri Lanka, at the time such instrument was presented in Sri Lanka,

at the rates specified by the Minister by order published in the Gazette. It is imposed on certain documents and charged on prescribed rates on the value of documents. Stamp Duty is governed by the **Commissioner General of Inland Revenue** and **Provincial Revenue Commissioners** with their capacity.
- **Share Transaction Levy (STL)** - STL is levied on both seller and buyer of shares on same transaction when shares are transferred through the Colombo Stock Exchange.
- **Excise Duties** – Excise duties are mainly charged on sale of liquor and tobacco products in Sri Lanka by the **Excise Commissioner**.

**CHAPTER ROUND UP**

- ↳ Financing of public expenditure is the primary purpose/objective of taxation.
- ↳ Secondary functions/objectives of taxation can be identified under economic and social functions of taxation.
- ↳ Equity, progressivity, simplicity and certainty are some of the principles of taxation.
- ↳ Direct taxes should be paid by taxpayer directly to the Government whereas indirect taxes collected by a person other than the person on whom the tax is imposed.
- ↳ Department of Inland Revenue, Provincial Departments of Revenue, Department of Customs and Department of Excise are the main Tax Authorities in Sri Lanka.
- ↳ Income Tax, Value Added Tax, Nation Building Tax, Stamp Duties, Import Duties, Share Transaction Levy and Excise Duties are considered as major taxes in Sri Lanka.

**PROGRESS TEST**

- 1 **Explain** the statement: “Value Added Tax (VAT) is an indirect tax in Sri Lanka”.
- 2 **Explain** the concept of progressivity in taxation.
- 3 **List** three social functions of taxation.
- 4 **List** principles of taxation.
- 5 **State** major tax collection authorities in Sri Lanka.

- 1 VAT is imposed on the final/ultimate consumer of products and services. It is collected by a person other than the person on whom the tax is imposed. Therefore, it is considered as an indirect tax.
- 2 Progressivity concept states that the rate of tax should be increased with taxpayer's income. In other words, tax burden should be proportionate to taxpayer's income level and ability to pay. This links with the concept of vertical equity and ability to pay principle. The ultimate expectation of this principle is to ensure that people with higher income pay more taxes than people with lower income.
- 3
 - (i) Discourage activities which are undesirable by the society
 - (ii) Encourage activities which are desirable by the society
 - (iii) Reduce income disparity between rich and poor
- 4 The following are the principles of taxation:
 - Equity
 - Progressivity
 - Efficiency
 - Adequacy
 - Certainty
 - Broad base
 - Simplicity
 - Convenience and voluntary compliance
- 5 Major tax collection authorities in Sri Lanka:
 - Department of Inland Revenue
 - Provincial Departments of Revenue
 - Department of Customs
 - Department of Excise

Income Tax liability of a Resident Individual

Knowledge Component

B. Income Tax Liability of a Resident Individual

2.1 Imposition of Income Tax	2.1.1	Identify the Statutory provisions applicable to income tax.
	2.1.2	Explain the chargeability of income tax to a person under the Inland Revenue Act.
	2.1.3	Explain the chargeability of income tax to a person under the Inland Revenue Act.
2.2 Statutory income from sources of income and income listed in the Inland Revenue Act	2.2.1	Calculate assessable income from a business of small and medium scale enterprise taking into consideration allowable and disallowable expenses and realisation of capital assets.
	2.2.2	Calculate assessable income from employment (including all cash and non-cash benefits).
	2.2.3	Calculate assessable income from investment (excluding gains from realisation of investment assets in chapter 4).
2.3 Taxable Income	2.3.1	Calculate taxable income taking into consideration relevant qualifying payments and reliefs.

CHAPTER CONTENTS

1. Imposition of Income Tax
2. Income sources
3. Taxable income

LEARNING OUTCOME

- 2.1.1, 2.1.2, 2.1.3
2.2.1, 2.2.2, 2.2.3
2.3.1

1.0 Imposition of income tax**1.1 Statutory Provisions applicable to Income Tax****(a) Inland Revenue Act**

The main Act which is applicable to the imposition of income tax in Sri Lanka is the Inland Revenue Act, No. 24 of 2017 (IR Act). The IR Act has been introduced with effect from April 01, 2018. Hence, no amendment has yet been introduced. The previous Inland Revenue Act, No. 10 of 2006 is not applicable for any year of assessment commencing on or after 01st April 2018 unless the IR Act specifically mentioned its application. In this regard, Gazette Notification No. 2064/53 dated 01st April 2018 has been issued on transitional provisions.

(b) Gazette Notifications

From time to time, the Minister or administrators of income tax may issue gazette notifications with regards to the implementation of IR Act. Such gazette notifications would also become part of the legal framework for taxation.

(c) Case Laws

Legislature (the Parliament) enacts laws, whereas the interpretation of such laws is vested with the Judiciary. Under Common Law (English Law) principles, the decisions of higher Courts become precedent and are considered examples in subsequent matters. Therefore, some of the cases on tax matters previously decided based on previous Inland Revenue Acts would also become part of the legal framework for tax.

(d) Rulings

In order to achieve uniformity on contentious issues in administering the tax system, tax administrators being the Department of Inland Revenue (the IRD) may issue public rulings as well as private rulings. A ruling is a determination, or a method accepted by tax administrators for a particular scenario or an issue. Such rulings could be useful for Revenue officers as well as taxpayers in the future to identify similar issues or scenarios subject to certain restrictions.



QUESTION

State the main components of the law applicable to income tax

ANSWER

- i. Inland Revenue Act, No. 24 of 2017.
- ii. Case laws decided by the Judiciary.
- iii. Gazette notifications issued.
- iv. Rulings issued by the Department of Inland Revenue

1.2 Chargeability of Income Tax

Income tax is payable for each year of assessment by a **person** who has **taxable income** for that year or a person who receives a **final withholding payment** during the year.

Section 2 of the Inland Revenue Act (which is the charging section) states that the amount of tax payable is the total of the tax payable on the **taxable income** and tax payable on **final withholding payments**.

Tax payable on the taxable income as well as on withholding payments are to be calculated by applying the relevant tax rates set out in the First Schedule. Withholding tax credits as well as foreign tax credits can be claimed against the tax payable on the taxable income. However, final withholding payments are not considered as part of the taxable income and therefore no withholding credit is claimable.

1.2.1 Meaning of “Person”

Income tax is payable by a “person”. It is therefore important to understand the interpretation of the word “person” given in the Act.

“person” means an individual or entity and includes a body of persons corporate or unincorporate, an executor, non-governmental organization and charitable institution.

The word “person” is defined as an exhaustive definition covering the following.

- i. An individual and an entity
- ii. It includes
 - (a) a body of persons corporate or unincorporate
 - (b) an executor
 - (c) a non-governmental organization
 - (d) a charitable institution

1.2.2 Meaning of “Year of Assessment”

The “year of assessment” is defined as follows.

*The year of assessment **means** the period of twelve months commencing on the first day of April of any year and ending on the thirty first day of March in the immediately succeeding year*

For instance, year of assessment 2018/2019 covers the period from April 01, 2018 to March 31, 2019.

2.0 Taxable Income

The “**taxable income**” means the total of assessable income after deducting qualifying payments and relief for the year of assessment from employment, business, investment and other sources. When computing the assessable income from these sources, exempt amounts and final withholding payments need to be removed.

Taxable Income = Total Assessable Income – qualifying payments & reliefs

2.1 Basic Reliefs and Qualifying payments – 5th Schedule

2.1.1. Basic Reliefs

- Rs.500,000/- per year of assessment to any resident individual or to any nonresident individual but a citizen of Sri Lanka.
- Rs.700,000/- per year of assessment, up to the total of the employment income of a resident individual.
- Up to Rs.1,500,000/- against interest income of a Senior Citizen who is resident and citizen of Sri Lanka.
- An amount equal to 25% of rental income received by an individual from an investment asset on account of repair, maintenance and depreciation.
- Income earned in foreign currency from service rendered to any person outside Sri Lanka, to be utilized outside Sri Lanka, up to Rs.15 Mn. limited to the total of such income for the year.

2.1.2. Qualifying payments

- a) a donation made by an individual in money to an approved charitable institution that is:
- (i) a charitable institution established for the provision of institutionalized care for the sick or the needy; and
 - (ii) declared by the Minister as an approved charitable institution for the purposes of this sub-paragraph, subject to a maximum of-
 - The claimable amount in respect of donations to Approved Charities is restricted to lower of 1/3 of the taxable income or Rs.75,000
 - Unclaimed amount, if any, cannot be carried forward
- b) Donations made in money or otherwise to the Government and to certain prescribed Institutions is claimable at 100%. **but unclaimed amount, if any, cannot be carried forward.** The following are the institutions mentioned in the Act.
- a local authority;
 - any Higher Education Institution established under the Universities Act
 - the Buddhist and Pali University of Sri Lanka or any Higher Educational Institution established under the Buddhist and Pali University of Sri Lanka Act;
 - a fund established by the Government of Sri Lanka;
 - a fund established by a local authority or by a Provincial Council and approved by the Minister;
 - the Sevana Fund of the National Housing Development Authority
 - the Api Wenuwen Api Fund;
 - National Kidney Fund.

2.1.3 Transitional Provisions on qualifying payments

As per the transitional provisions mentioned in the gazette notification No 2064/53 dated April 1, 2018, any unclaimed balance of qualifying payment as at March 31, 2018 which has been claimed as per section 34 of the Inland Revenue Act, No. 10 of 2006 is deductible as an allowance in ascertaining the taxable income of any person for any year of assessment commencing after April 1, 2018 subject to any conditions specified in the provisions of the new IR Act.

3.0 Total Assessable Income

The total assessable income of an individual for a year of assessment is the aggregate of following elements:

- Assessable income from employment
- Assessable income from business
- Assessable income from investments
- Assessable income from any other source

Inland Revenue Act states the chargeability of income tax as follows:

- **A resident person:** on the income from employment, business, investment and other sources for a year of assessment wherever the source arises. That is his world income;
- **Non-resident person:** on the income from employment, business, investment and other sources for a year of assessment subject to such income **arises in or is derived from a source in Sri Lanka.**

Therefore, it is important to understand the rules determining the residency of any individual.

3.1 Residential Status of an Individual

The taxation of an individual is based on his residential status. Residency under tax law is different from the general meaning of residency.

The ambit of Sri Lankan tax legislations extends to the geographical area belonging to Sri Lanka. Therefore, Sri Lankan tax laws are applicable only to persons based in Sri Lanka or those who receive income from Sri Lanka.

As stated in section 69, the residential status of an individual for the purpose of taxation is determined under the following criteria.

- **Qualitative test;**

If an individual resides in Sri Lanka, he shall be a resident in Sri Lanka. The Act does not define what is meant by "reside" Hence, needs to adopt the ordinary meaning of the word for this purpose, namely, to have one's normal place of abode in or at a particular place or else decides based on whether the individual has a home regularly available for use in Sri Lanka. In this regard, the location of the individual's family, the location of the person's economic and social interests, including the dependence of the family on the individual for economic support, duration and frequency of visits to Sri Lanka are also important. In summary, it considers the social and economic relationship of the individual. If any individual is treated as a resident under this rule, quantitative test is not required to be tested.

- **Quantitative test;**

If an individual is present in Sri Lanka during the year and that presence falls within a period or periods amounting in aggregate to 183 days or more, in any 12 month period that **commences or ends** during the year; he shall be resident in Sri Lanka.

- **Residual Tests**

If an individual is an employee or an official of the government of Sri Lanka and his spouse is posted abroad during the year; he shall be a resident in Sri Lanka.

Based on the types of work, a residence of an individual could be decided. When the officials of government are posted abroad to work for a Mission of the government, he is treated as a resident irrespective of the number of days that he stays in that country. In this case, not only the employees, but their spouses (if their spouse is abroad with them) are treated as resident of Sri Lanka.

If an individual is an individual who is employed on a Sri Lanka ship, within the meaning of the Merchant Shipping Act, during the period the individual is so employed, he shall be a resident in Sri Lanka.

A residency of an employee who works for a shipping enterprise cannot be determined by counting number of days physically present in a country since a ship is all over the world during any year. Hence, he may be away from Sri Lanka for extended periods of time. Due to that fact, residency is determined based on whether he is employed on a ship registered under the Merchant Shipping Act or not.



Example: Determination of residence status based on the qualitative test

Ruwan Fernando has been transferred for two years to a branch of the company which is in India. He decided not to accompany with the family since the children are schooling here and wife is working here. He has a permanent home available in Sri Lanka, and his bank accounts are continued to be maintained for remitting his salary to Sri Lanka. However, he has given up his club memberships and sold his motor car. He has rented out an apartment in India, and when he is free, he flies to Sri Lanka at least once in three months.

Determining whether Ruwan Fernando is a resident of Sri Lanka requires balancing the weight of social and economic connections to Sri Lanka against his connections to India. Although he has a home in India, he maintains close ties to Sri Lanka. Hence, he is a resident of Sri Lanka.



Example: Determination of residence status based on the Quantitative test

Kinshu Swong has joined with Hope (Lanka) Ltd as the Residence Representative of Sri Lanka on a thirty-two months contract. Hope (Lanka) Ltd is a branch of a company in Hong Kong, and Swong is required to look after two other branches in Maldives and Mauritius. He visited Sri Lanka on the 15th July 2018 to resume duties keeping his family in Hong Kong.

He has to travel its head office and other branch offices for business matters. His travel schedule for the entire period is as follows:

Date of arrival	Date of Departure	Period of stay in Sri Lanka (days)
15.07.2018	21.10.2018	99
11.11 2018	20.12 2018	40
01.06. 2019	30.10.2019	122
01.11.2019	31.12.2019	61
18.02.2020	12.05.2020	84

Swong is a resident for the year 2018 (2018/2019) as he is physically present in Sri Lanka for at least 183 days in a 12 months period that **commences** during the 2018 year. i.e. from 15th July 2018 to 14th July of 2019 (99 days + 40 days + 45 days).

He is a resident for the year 2019 (2019/2020) since his physically presence in Sri Lanka is more than 183 days within 12 months period commencing or ending in the year 2019.

He is a resident for the year 2020(2020/2021) since he is physically present in Sri Lanka for more than 183 days within 12 months period ending on 31st March of the year 2020 (2020/2021) (i.e. from 13th May 2019 to 12th May 2020), irrespective of the fact that he is physically present in Sri Lanka only 42 days during the year of assessment 2020/2021.

QUESTION

Explain the rule applicable in determining residency for an individual which is effective from 01st April 2018.

ANSWER

If an individual resides in Sri Lanka or is physically present in Sri Lanka in aggregate to 183 days or more, during any 12 months period that commences or ends during the year, he is considered as a resident individual.

In addition, where any official of the government of Sri Lanka are posted abroad to work for a Mission of the government, or an individual who is employed on a Sri Lanka ship, within the meaning of the Merchant Shipping Act, are considered as resident in Sri Lanka and the 183 days rule will not affect in their cases.

4.0 Calculation of Assessable income from employment

In this section, we cover how to calculate assessable income from employment and what are the different types of employee benefits liable to tax.

4.1 Benefits taxable under employment income

The assessable income of an individual from employment includes all the benefits received, whether in cash or otherwise, by such individual in consideration for the services rendered by him during any year of assessment.

As per the Inland Revenue Act, “**Employment**” means:

- i. a position of an individual in the employee of another person,
- ii. a position of an individual as manager of an entity,
- iii. a position of an individual entitling the individual to a fixed or ascertainable remuneration in respect of services performed,
- iv. a public office held by an individual,
- v. a position of an individual to whom any payment is made or due by or from an employer or who receives any other benefit as an employee or in a similar capacity,
- vi. a position as a corporation or company director.

and

Includes a past, present or prospective employment

“**Employee**” means an individual engaged in employment.

Any payment is received in respect of past or future employment is also considered as employment income.

Employment income should be accounted on cash basis.

4.2 Cash benefits

- Payment of salary, wages, leave pay, overtime pay, fees, pensions, commissions, gratuities, bonuses and other similar payments.
- Payment of personal allowances, including any cost of living, subsistence, rent, entertainment or travel allowance;
- Payments providing discharge or reimbursement of expenses incurred by the individual or an associate of the individual; However, if such discharge or reimbursement of expenses incurred by the individual on behalf of the employer is not subject to tax.

- Payments for the individual's agreement to conditions of employment.
- Payments for redundancy or loss of termination of employment.
- Payment or transfers to another person for the benefit of the individual or an associate person of an individual.

Associate is defined to say that two persons are associates or associated persons where the relationship between the two is that of an individual and a relative of the individual, and

“relative” means the individual's child, spouse, parent, grandparent, grandchild, sibling, aunt, uncle, nephew, niece or first cousin, including by way of marriage or adoption.

- Other **payments**, including gifts received in respect of employment.

Students should note that any benefits received such as gift is taxable if it is received only in respect of the employment.

As per the Act, **“payment”** means the conferring of a value or a benefit in any form by one person on another person and includes –

- a) the transfer by one person of an asset or money to another person or the transfer by another person of a liability to the one person;
- b) the creation by one person of an asset that on creation is owned by another person or the decrease by one person of a liability owed by another person;
- c) the provision by one person of services to another person; and
- d) the making available of an asset or money owned by one person for use by another person or the granting of use of such an asset or money to another person;

For an example, if an employee has taken a loan from a bank, then he is required to make the repayments to the bank. However, his employer has made the repayment directly to the bank instead of paying the salary to him, it is considered as payment made to the employee and it is the income from employment.

4.3 Value of non-cash benefits

The fair market value of benefits received or derived **by virtue of the employment** by an individual or an associate person of an individual is considered as noncash benefit under the employment income.

The phrase “by virtue of employment” is designed to be broad in its application. The benefit would not have been received, but it is for the employment, then it is considered as a benefit received by virtue of employment.

Commissioner General has issued circular giving values for certain non- cash benefits.

- The taxable value of the provision of hotel facilities for expatriates, Provision of servants etc., provision of electricity and gas etc. provision of medical benefits, provision of free meals, air tickets (other than official purposes), is 100% of the cost.
- The taxable value of telephone bills is only 50% of the amount paid.
- Payment of tax by the employer is the amount of tax paid.
- When the concessionary loans are given by the employer, it needs to be taken as 50% of difference between concessionary rate and the market rate specified annually by CGIR. For the year of assessment 2018/2019, market rate specified by CGIR is 9.08%.
- The taxable value of payment of dental, medical or health insurance is 100% of the cost. However, if such discharge or reimbursement is with regard to dental, medical or health insurance expenses which is applicable to all full-time employees on equal terms, then it is excluded from employment income;
- Payments made to or benefit accruing to employees on a non- discriminatory basis that, by reason of their size, type and frequency, are unreasonable or administratively impracticable for the employer to account for, or to allocate to the individual, then it is to be excluded from the employment income. For example, tea provided by the employer.

Value of Shares

The market value of shares at the time allotted under an employee share scheme, including shares allotted as a result of the exercise of an option or right to acquire the shares, reduced by the employee's contribution for the shares are considered as employment income. However, the value of a right or option to acquire shares at the time granted to an employee under an employee share scheme is not taxable.

Value of Residence provided by the Employer

The Commissioner General has specified the value of this benefit by issuing a circular. It says that the "Value" of any benefit of any place of residence provided by the employer should be the market value or the value specified in the circular where the market value is not ascertainable. The following is the value specified on certain situations.

If the monthly remuneration is less than or equal to Rs. 200,000, and the residence is in a,

Rated area	Rs.20,000 or 12.5% of the remuneration whichever is less
Unrated area	Rs.15,000 or 10% of the remuneration whichever is less
Estate bungalow	Rs.10,000 or 7.5% of the remuneration whichever is less

If the monthly remuneration is more than Rs. 200,000, and the residence is in a,

Rated area	Rs.40,000 or 12.5% of the remuneration whichever is less
Unrated area	Rs.30,000 or 10% of the remuneration whichever is less
Estate bungalow	Rs.20,000 or 7.5% of the remuneration whichever is less

- If the residence is provided with furniture, 2.5% of the remuneration or Rs.5,000 whichever is less should be taken in to account.
- Any expenditure reimbursed by the employer in connection with a house or apartment occupied by the employee, the actual cost to the employer is the value of benefit.

Value of transport facilities provided by the employer.

The full amount of the market value is the benefit from the private use of vehicle (fully or partly). If the market value is not ascertainable, any benefits from vehicle will be valued as follows:

(Value per month in rupees)

Engine	Vehicle	Driver	Fuel
<ul style="list-style-type: none"> ▪ Not more than 1800cc - Fuel or Hybrid(Petrol/Diesel) ▪ Not more than 200KW Electrical Vehicles 	20,000	10,000	20,000
<ul style="list-style-type: none"> ▪ More than 1800 cc - Fuel or Hybrid (Petrol/Diesel) ▪ More than 200 KW Electrical Vehicles 	35,000	10,000	30,000
<ul style="list-style-type: none"> ▪ Motorcycle - with fuel -5,000 -Without fuel - 3,000 			

- If an employee provided with more than one vehicle for official or private use, only one vehicle should be considered as provided for private use and as the benefit from employment for PAYE tax purpose.
- When the employer maintains accurate records in respect of vehicles or bicycles provided to be used **for field works**, benefit is Rs.25 or Rs.5 per kilometer, as the case may be, (irrespective of the engine capacity of the vehicle).
- Any expenditure reimbursed by the employer in respect of fuel or maintenance of any motor vehicle or bicycle, the actual cost to the employer is the value of benefit.

4.4 Retirement benefits

Payments for redundancy or loss or termination of employment, and retirement contributions made to a retirement fund on behalf of the employee and retirement payments received in respect of the employment are income from employment. However, contributions made by an employer to an employee's account with a pension, provident or savings fund approved by the Commissioner-General is excluded from employment income.

4.5 The following receipts and benefits do not form a part of the assessable income from employment

- A discharge or reimbursement of expenses incurred by the individual on behalf of the employer.
- A discharge or reimbursement of an individual's dental, medical or health insurance expenses where the benefit is available to all full-time employees on equal terms. It is understood that equal terms means not for all the employees, but for a set of employees under the same level.
- Payments made to or benefits accruing to employees on a non-discriminatory basis that by reason of their size, type and frequency are unreasonable or administratively impracticable for the employer to account for, or to allocate to the individual.
- The value of a right or option to acquire shares at the time granted to an employee under an employee share scheme. It means at the point where the option is given, the benefit is not taxed, but tax applies when the shares are allotted after exercising the option.
- Contributions made by an employer to an employee's account with a pension, provident or savings fund approved by the Commissioner-General.

4.6. Employment income exempt from income tax

As per the Third schedule of the Inland Revenue Act, the following receipts and benefits are exempt from tax.

- Capital sums paid as a compensation or gratuity in relation to personal injuries or death.
- Pension received from the Sri Lankan Government or from a department of the Government.
- Amounts paid on retirement from any pension fund or the Employees' Trust Fund, representing investment income earned for any period commencing on or after 1 April 1987.
- Amounts paid on retirement from any provident fund approved by the Commissioner General of Inland Revenue.

- Income derived by an individual entitled to privileges under the Diplomatic Immunities Law and other specified conventions and Regulations.
- Benefits derived by a government employee, from a road vehicle permit granted to such employee.



QUESTION

Assessable Income from Employment

Mr. Gunasekara is a Senior Manager of a large mercantile organisation. He has given his primary employment declaration to this organization. In addition, he serves as a Director of a subsidiary company of the group. The following information has been provided for the Y/A 2018/2019 to calculate his assessable income from employment.

He is entitled to a monthly salary of Rs.120,000, of which the company and Mr. Gunasekara contribute 12% and 8% respectively to the Employees Provident Fund (EPF). In addition, he received an entertainment allowance of Rs.15,000 per month, and a bonus equivalent to three months' salary from the profit for the Y/A2017/2018. Leave encashment paid during the above year of assessment is Rs.36,000.

- He has been provided with an 1800cc for his official and private use, with fuel and a driver.
- The following amounts were reimbursed by the company during the year:
 - Reimbursement of food and lodging expenses on official visits to branches: Rs.42,000.
 - Reimbursement of health insurance expenses (the benefit is available for all full time employees in equal terms) :Rs.75,000.
 - His annual subscription to the Institute of Professional Managers: Rs.25,000.
 - Touring expenses of his daughter who was selected to represent the national netball team: Rs.125,000.
 - Residential telephone bills:Rs.60,000.
 - He lives in a house provided by the company taken on a monthly rental of Rs.20,000.
- The director's fee received from the subsidiary company which is his second employment was Rs.216,000, and it is net of withholding tax.

Required: to Calculate income from employment for the Y/A 2018/2019.

ANSWER

	Rs.	Rs.
Salary	120,000 x 12	1,440,000
Contribution to EPF by employer	Not taxable	0
Entertainment allowance	15,000 x 12	180,000
Bonus on cash basis	120,000 x 3	360,000
Leave encashment		36,000
Vehicle benefit—1800cc car with	Vehicle - 20,000 Driver - 10,000 Fuel - 20,000 50,000 x 12 = 600,000	600,000
Official expenses reimbursed	Not taxable	0
Family medical bills	Not taxable	0
Professional subscription paid by employer	Taxable benefit	25,000
Grant for daughter's achievement	Taxable	125,000
Residential telephone bills	Rs. 60,000 x 50%	30,000
Housing benefit		
Rent paid to the owner	20,000x12	
Benefit is the actual cost		<u>240,000</u>
Income from primary employment		3,036,000
Director fees from 2nd employment		240,000
Assessable income from employment		3,276,000



PROGRESS TEST

Mr. Samaraweera is a Chartered Accountant working for a bank since 2010. The following is the information relating to his employment income for the Y/A 2018/19.

- Basic salary- Rs.360,000 per month after deducting 10% to the provident fund. The employer's contribution to this fund is at 15%. The fund has been approved by the CGIR.
- He is provided with a motor vehicle which has been hired from a company paying Rs.50,000 per month.
- Fuel allowance is also paid amounting to Rs.50,000 per month.
- Bonus paid based on the previous year profit, and it is one month of the basic salary.
- Telephone allowance is Rs.8,000 per month.
- Leave encashment paid is Rs.75,000.
- Entertainment allowance is Rs.10,000 per month.
- The residence provided to Mr. Samaraweera is owned by the employer and it is in a rated area. Furniture has also been provided.
- His daughter was admitted to a private hospital and the bill amount was Rs.200,000, and it was settled by his employer from an insurance scheme which is applicable for all fulltime employees on equal terms.
- Life insurance premium of Rs. 10,000 per month is reimbursed by the employer.
- An option has been given to purchase 1000 shares of the bank. However, this option can be exercised only after 1 May of the year 2020.

Compute the income tax to be paid for the Y/A 2018/19.

Answer:

The computation of income tax liability of Mr. Samaraweera for the year of assessment 2018/19.

	Income Rs.	Exempt/ Excluded Rs.	Liabe Rs.
Basic salary $\frac{360,000 \times 100}{90} \times 12$	4,800,000		4,800,000
Employer's con; $400,000 \times 15\% \times 12$	720,000	720,000	
Vehicle Benefit $50,000 \times 12$	600,000		600,000
Fuel allowance $50,000 \times 12$	600,000		600,000
Bonus paid on cash Basis	400,000		400,000
Telephone Allowance $8,000 \times 12$ This is an allowance.	96,000		96,000
Leave encashment	75,000		75,000
Entertainment allowance, $10,000 \times 12$	120,000		120,000
Residential Benefit (i) $6,216,000 \times 12.5\% = 777,000$, or (ii) 40,000 whichever is lower. Lower of (i) or (ii) is the residential benefit	480,000		
Furniture benefit (i) $6,216,000 \times 2.5\% = 155,400$ or (ii) 5,000 whichever is lower Lower of (i) or (ii) is the furniture benefit	60,000		540,000
Medical Expenses paid on daughter's hospitalization		200,000	
Life insurance premium reimbursed	120,000		120,000
Share option is not materialized. Hence, no tax			
Income from Employment			7,351,000

5.0 Calculation of Assessable income from business

A person's income from a business for a year of assessment is the person's gains and profits from conducting the business for the year, and it is liable to income tax. Therefore, it is necessary to understand what is included in a business.

5.1 Definition of a Business

The business is defined in the interpretation section 195 of the Inland Revenue Act, to say that,

“Business”

- a) includes
 - i. a trade, profession, vocation or isolated arrangement with a business character however short the duration of the arrangement;
 - ii. a past present or prospective business, but
- b) excludes an employment

The definition of "business" in section 195(1) specifically excludes "employment". Therefore, if an activity amounts to employment, it cannot also be a business. Further, if an activity amounts to a business, it cannot also be an investment. This is what incorporated to the law as dominancy principle. One is dominant over the other. Hence, a person is just passively holding assets, in that case, he has an "investment" rather than a "business. Accordingly, it is very important to understand what constitutes a business.

As per the above definition, business includes trade, profession or vocation. However, there are no definitions given for trade, profession or vocation. Therefore, it must be understood according to their general meaning. The combined effect of these terms is that any person actively engaged in deriving money from the provision of their labour (services) will be engaged in a business (if they are not an employee).

5.1.1 Trade

In order to decide whether there is any trade or not, we must see that,

- whether a person has purchased some commercial quantities of items which are more than enough for him,
- if such articles are held for a short period,
- transactions are repetitive
- anything has been done to have a saleable item,
- any such motivation to make profits, etc.

If so, it can be determined that there is a trade.

5.1.2 Profession and Vocation

Any person engaged in professional activity with his special skills and knowledge, it is his profession. He may have obtained such a skill from an institution following a course or a program. For an example, a Chartered Accountant engaged in accounting practice. Vocation is an occupation to which a person is specially drawn or for which she or he is suited, trained or qualified. Most probably out of his in born skills. For example, singer, actor, etc.

5.2 What constitutes a business?

- Service fee
- Consideration received in respect of trading stock
- Gain from realisation of capital assets and liabilities of the business
- Amount calculated from realization of depreciable assets of the business
- Consideration for accepting a restriction of business capacity
- Gifts received in respect of business
- Amounts derived that are **effectively connected** with the business and that would otherwise be included in calculating the person's income from an investment
- Other amounts required to be included under the Act

But excludes,

- Exempt amounts and final withholding payments
- Amounts included in calculating person's employment income

Consideration for accepting a restriction of business capacity is a new concept incorporated to the Act. For example, sometimes a person may receive some amount for agreeing not to do a business.

Gifts received in cash or in-kind in respect of a business is also a new concept as above. When a gift is received, it is considered as a part of the business income. However, if the gift is in kind of a trading stock, a depreciable asset or business asset, then it will have a cost equal to the amount included in the income as per this provision.

Any income that a person might derive from an asset without active engagement, it is considered as investment income. However, if an amount is derived in the context of a business which has an "effective" connection with a business, it is treated as business income irrespective of whether it is mentioned in section 7 which explains as the investment income.

5.3 Computation of gains and profits from business

In order to arrive at the assessable income from business, all expenses incurred in the production of income are allowed as deductions, including certain specific expenditure but prohibiting the deduction of certain other specified expenditure mentioned in **the Inland Revenue Act**.

Therefore, one must adjust the book profit or accounting profit to fit into the provisions of the Act to arrive at the assessable income for tax purposes. Accordingly, assessable income is computed as follows.

	+	-
Net profit before tax	x	
Less: exempt income/ final withholding payments , Other amounts that are included in the employment or investment income		x
Add: Disallowable expenses	x	
Less: Allowable expenses		x
Assessable income from business	<u>x</u>	<u>x</u>

5.3.1 Disallowable and Allowable expenses

All expenses to the extent they are incurred during the year in the production of income from the business or investment is allowable to deduct when ascertaining the income from business and investment (Section 11 of the Inland Revenue Act). However, as per section 10 of the Act, certain expenses are to be disallowed. Certain other Sections i.e. section 12, 13,14,15,16,17,18 and 19, specifically allows certain expenses.

No deduction is allowed for an expense of capital nature Section 11(2). “Expense of a capital nature” includes an expense that secures a benefit capable of lasting longer than twelve months.

5.3.2 Disallowable expenditure

In calculating income from any source, following are not allowed. (Sec.10 (1) (b))

- Domestic expenses – details given in Section 197.
- Tax payable under this Act and taxes or other levies specified by the CGIR in the Gazette Notification No. 2064/54 dated 01.04.2018
- Interest, penalties and fines payable to a Government or political sub division of a Government for breach of any written law in any country,
- Expenditure incurred in deriving exempt or final WHT amounts,
- Retirement contributions (by the employer): (if the benefit is taxing on the employee or contributed to a fund approved by the CGIR, such contributions are allowed)
- Dividends of a company,
- Entertainment expenses or outlays,
- Reserves or provisions,
- Expenses incurred on lotteries, betting or gambling unless in the course of conducting such a business.

5.3.3 Domestic expenses to be disallowed.

- a) Where an individual incurs expenditure for himself:
- in maintaining him, including in providing shelter as well as meals, refreshment, entertainment or other leisure activities;
 - for commuting from home;
 - in acquiring clothing, including shoes, for him, other than clothing that is not suitable for wearing outside of work;
 - in educating him, other than education that is directly relevant to a business conducted by him and that does not lead to a degree or diploma; or
 - in paying any personal debts, including credit card debts, of the individual.
 - in paying any interest incurred with respect to money borrowed by him and used for himself,

It is considered as domestic expense.

- b) Where another person incurs expenditure in making payment to or providing any other benefit for an individual, the expenditure is domestic except to the extent that:
- the payment or benefit is included in calculating the income of the individual;
 - the individual provides consideration of an equal market value for the payment or benefit; or
 - the amount of the expenditure is so small as to make it unreasonable or administratively impracticable to account for it.

In the situations (a) and (b) above cover any interest incurred with respect to money borrowed by an individual and used for himself or another person has incurred expenditure in making interest payments for the benefit of another person, as the case may be.

5.3.4 Taxes to be disallowed

- Income tax payable under the Inland revenue Act, or any income tax or similar tax payable to another country (other than the excess of any such income tax, over such maximum credit)
- Economic Service Charge
- VAT or NBT on Financial Services
- Crop Insurance Levy
- Supper gain tax, Bars and Taverns Levy, Casino Industry Levy, Mobile Telephone Operator Levy, Satellite Location Levy, Dedicated Sports Channel Levy and Mansion Tax.

5.4. Deductions which are specifically allowed

Certain expenses are specifically mentioned as allowable deductions. In such a situation, deduction should be made under that specific section rather than considering the general deduction section.

5.4.1 Interest Expense

Interest incurred during a year of assessment under a debt obligation is deductible if the money borrowed was utilized for the production of income or to acquire an asset used in the business.

For this purpose 'debt obligation' means an obligation to make a payment to another person that is denominated in money, including accounts payable and the obligation arising under deposits, debentures, stocks, treasury bills, promissory notes, bills of exchange and bonds.

5.4.2 Trading Stock

The deduction for the allowance for trading stock is allowed and for determining the allowance for trading stock it needs to follow the generally accepted accounting principles. A formula has been given in section 13. The determination of the cost is explained in section 42.

The opening value of trading stock of the business for the Y/A	xxx
plus: expenses incurred during the year that are included in the cost of trading stock of the business	xxx
	<hr/>
less: closing value of trading stock of the business for the year.	(xx)
Allowance for trading stock	xxx

5.4.3 Research and development expenses and agricultural startup expenses

Research and development expenses and agricultural startup expenses can be deducted irrespective of the fact that they are capital nature or not. However, if the research expenses incurred are included in the cost of the asset, then it is to be excluded.

"Agricultural startup expenses" means expenses in opening up any land for cultivation or for animal husbandry, cultivating land with plants, the purchase of livestock or poultry to be reared on land or maintaining tanks or ponds or the clearing or preparation of any inland waters for the rearing of fish and the purchase of fish to be reared in such tank, pond or inland waters.

"Research and Development expenses" means expenses incurred in carrying on any scientific, industrial, agricultural or any other research for the upgrading of the business through any institution in Sri Lanka (or for any innovation or research relating to high value agricultural products, by the person or through any research institution in Sri Lanka). or the process of developing the business and improving business products or process, which should be beneficial to Sri Lanka.

As per the sixth schedule, a person is entitled to an additional deduction equal to 100% of the total amount of research and development expenses deducted for the year under section 15 as explained above, for three years of assessment after the commencement of the Act, No. 24 of 2017 (new expenses incurred after 1.4.2018).

5.4.4 Capital Allowances and Balancing Allowances

When calculating a person's income from a business for a year of assessment, capital allowances can be deducted under the second, fourth or sixth schedules and balancing allowances (loss from disposal of depreciable assets) can also be deducted.

As per section 16, capital allowance is granted on depreciable assets if it is owned and used at the end of the year of assessment in the production of the income from a business.

“depreciable asset” - as defined in section 195,

- (a) means an asset to the extent to which it is employed in the production of income from a business and which is likely to lose value because of wear and tear, obsolescence or the passing of time; but
- (b) excludes goodwill, an interest in land, a membership interest in an entity and trading stock;
 - It should be calculated according to the straight line method based on the second, fourth or sixth schedules
 - Capital Allowances should be calculated on the depreciation basis:

‘Depreciation basis’ is the sum of the depreciation basis of the asset at the end of the year of assessment and amounts added to the depreciation basis of the asset during the year of assessment in respect of additions to the cost of the asset.

- Capital allowances will be granted for the year of acquisition as the asset is owned and used at the end of the year of assessment.
- Capital allowance should not be deferred to a later year of assessment.
- Capital allowance is not granted in respect of road vehicles other than a commercial vehicle, a bus or minibus, a goods vehicle; or a heavy general purpose or specialised truck or trailer.

‘Commercial vehicle’ means, a road vehicle designed to carry loads of more than half a tonne or more than 13 passengers or vehicles used in a transportation or vehicles used in a rental business.

- Capital allowance will not be granted for the year of disposal as the asset is not owned and used at the end of the year of assessment.
- If the depreciable asset is partly used in the production of income from a business at the end of the year of assessment, the cost of and consideration received for the asset shall be apportioned according to the market value of that part of the asset that issued in the production of income from that business and that part not.

Class of the Asset, Description and number of years are as follows:

Class	Depreciable Assets	Number of Years
01	computers and data handling equipment together with peripheral devices	5
02	buses and minibuses, goods vehicles; construction and earthmoving equipment, heavy general purpose or specialised trucks, trailers and trailer-mounted containers; plant and machinery used in manufacturing	5
03	railroad cars, locomotives, and equipment; vessels, barges, tugs, and similar water transportation equipment; aircraft; specialised public utility plant, equipment, and machinery; office furniture, fixtures, and equipment; any depreciable asset not included in another class	5
04	buildings, structures and similar works of a permanent nature	20
05	intangible assets, excluding goodwill	The actual useful life of the intangible asset, or where the intangible asset has an indefinite useful life, then it is 20

The Formula for calculating capital allowance is A/B

A - the depreciation basis of asset at the end of the year of assessment

B - number of years (provided in the fourth schedule)

Depreciation basis of a depreciable asset of a person at the end of the year of assessment is the sum of,

- a) depreciation basis of the asset at the end of the previous year of assessment; and
- b) amounts added to the depreciation basis of the asset during the year of assessment in respect of additions to the cost of asset

Example

Computers and data handling equipment together with peripheral devices is an asset of class 1. Hence No. of years applicable is 5 years.

Description	Year	Cost LKR	Depreciation basis LKR	No of years	Depreciation for the year LKR	Cumulative Depreciation LKR	WDV LKR
Computer	2018/19	300,000	300,000	5	60,000	60,000	240,000
Printer	2018/19	200,000	200,000	5	40,000	40,000	160,000
Total					100,000	100,000	

Transitional Provision

The allowance for depreciation in respect of any -

- Capital asset acquired prior to April 1, 2006, any qualified building constructed or any building acquired prior to April 1, 2006 ;or
- capital asset acquired on or after April 1, 2006, but prior to April 1, 2018, any qualified building constructed or any building acquired on or after April 1, 2006, but prior to April 1,2018,

should be computed in accordance with the respective provision of the Inland Revenue Act, No. 10 of 2006 and be deducted.

5.4.5 Enhanced Capital allowance

Apart from the capital allowances mentioned above, enhanced capital allowances are allowed (in addition to the normal capital allowance) subject to the amount of investments mentioned in the second schedule in depreciable asset other than intangible asset in view of encouraging investments in Sri Lanka. This enhanced capital allowance is not available for expansion of an existing business.

The amount of investments and the appropriate rate for claiming the capital allowance are as follows

Criteria	Limitation	Percentage of capital allowance
Depreciable assets used in Sri Lanka other than the Northern Province	USD 3 million to 100 million	100%
	Exceeding USD 100 million	150%
Depreciable assets used in the Northern Province	Exceeding USD 3 million	200%
on assets or shares of a state owned company used in a part in Sri Lanka	Exceeding USD 250 million	150% allowed to the state owned company

5.4.6 Enhanced Capital allowance (Temporary Concessions)

Further to the above provisions, a capital allowance of 100% for expenses incurred on depreciable assets identified in the sixth schedule is granted if the investment is up to USD 03 million and if such depreciable assets are used in a part of Sri Lanka other than the Northern Province. If it is in the Northern Province, the capital allowance of 200% of expenses incurred is granted. This enhanced capital allowance is not available for expansion of an existing business.

Depreciable assets referred to in this shall be

- a) Class 1 (computers and data handling equipment together with peripheral devices) and Class 4 (buildings, structures and similar works of a permanent nature) assets; and
- b) Depreciable assets (other than intangible assets) comprising plant or machinery and fixed to the business premises.

5.4.7 Repair and Improvement expenses

Expenses incurred in respect of repair or improvement of depreciable assets can be deducted if the asset is used for the production of income for any year of assessment, irrespective of whether the expenses are of a capital nature or not. (This provision is not applicable for an investment asset because it is not a depreciable asset)

However, the claim is restricted to the lower of actual cost or

- i. in the case of repair or improvement to a **Class 4 depreciable asset** (buildings, structures etc), **5% of the written down value** of the asset at the end of the previous year,
- ii. in **all other cases, 20% of the written down value** of the asset at the end of the previous year.

“**Written down value**” of an asset means the cost of the asset less all capital allowances granted with respect to the expenditure included in the cost.

- It is allowed in the order in which the expenses are incurred.
- Excess expense for which a deduction has not been allowed as a result of the limitation is to be added to the depreciation basis of the asset.
- Repair cost is allowed based on the WDV at the end of the previous year of assessment. Hence, in respect of new assets purchased during the year or assets which were not put to use during the year of assessment, no repair cost is allowed since there is no WDV at the end of the previous year of assessment. In the subsequent year of assessment capital allowance is given on such repair cost.

5.4.8 Lease-hold assets purchased prior to 01st April 2018

As per the regulation 8 of the gazette notification issued on **Transitional provisions**, any profit, loss, receipt or payment in respect of any finance lease agreement entered into, prior to April 1, 2018, is to be computed in accordance with the respective provisions of the Inland Revenue Act, No. 10 of 2006 as explained below.

- a) In case of lease rentals paid for assets other than IT equipment (vehicles, furniture, machinery, etc.), the amount in excess of 1/5th of the total lease value p.a. is disallowed. Note that the lease rentals paid are deductible only in respect of assets qualified for allowance for depreciation when acquired as outright purchase.

For example, if a person acquires a lorry on a three-year lease on 1 April 2016 and paid a lease rental (including interest) of Rs.50,000 per month, he paid Rs.600,000 during the year. Even though he charges Rs.600,000 against profit, deduction for tax purposes was restricted as follows:

	Rs
Lease rentals paid during the year (Rs.50,000 x 12) 1/5 th	600,000
of the total lease value (Rs.50,000 x 36) 1/5 Deduction	360,000
allowed (whichever is lower)	360,000

- b) In the case of lease rentals paid on information technology (IT) equipment, the amount in excess of 1/4th of the total lease value is disallowed.
- c) Lease interest or stamp duty charged on such lease asset to the profit is not allowed.

5.4.9 Lease -hold assets purchased after 01st April 2018

- The lessee is treated as the owner of the leased asset.
- The lessee is treated as having acquired the asset at the commencement of the lease.
- Lessee is entitled to claim capital allowance on the cost
- Interest cost can be claimed.

5.4.10 Disposal of assets –Assessable Charge or balancing allowance

Where a depreciable asset of a person is realized, an assessable charge is to be included (profit) or a balancing allowance is to be granted (loss) in calculating the person's income.

Formula for calculating **assessable charge** is $A - B^*$

5.4.11 Assessable charge or balancing allowances are to be calculated

Assessable charge or balancing allowances are to be calculated in respect of depreciable assets realized during a year of assessment if capital allowances have been granted in that year of assessment or an earlier year of assessment in accordance with the provisions of the second, fourth or sixth schedules to this Act on such assets

Formula for calculating **balancing allowance** is $B - A^*$

*Where

A - is consideration received by the person during the year of assessment for the asset, and

B - is the written down value of the asset at the time of realization of the asset

- Written down value of the asset at the time of realization means the expenses incurred by a person in acquiring the asset reduced by all capital allowances granted to the person.
- When a person realizes a depreciable asset in selling the business for which the expenses were incurred to another person who is an associate, then assessable charge or balancing allowance is not required to be computed as explained in paragraph (3) of the fourth schedule.
- Assessable charge (profit from the disposal) is to be added or balancing allowance (loss from the disposal) is to be deducted at the tax computation in respect of depreciable assets realized during the year of assessment and capital allowance have been granted in that year or an earlier year in respect of such assets.
- Any gain on a capital asset, for which allowance for depreciation is not granted, is considered as a business income if such capital asset is effectively connected to the business. However, for the purpose of calculation the gain, one must use the method which is used for capital gain calculation. For an example of sale of a land or for vehicles used for travelling.



Example (i): Disposal of assets- under the IR Act No.10 of 2006

A lorry purchased in the year of assessment 2013/2014 for Rs.750,000 was sold in the year of assessment 2018/2019 for Rs.400,000. Profit on disposal is:

Assessable Charge	Rs
Cost (2013/2014)	750,000
<i>Less: Depreciation allowed</i>	
2013/2014 - 20%	(150,000)
2014/2015 - 20%	(150,000)
2015/2016 - 20%	(150,000)
2016/2017 - 20%	(150,000)
2017/2018- 20%	(150,000)
Written down value	NIL
Selling price	400,000
Less: Written down value	(0)
Profit on disposal	400,000



Example (ii): Disposal of assets- under the IR Act, No.10 of 2006

If a lorry purchased for Rs.600,000 in 2015/2016 was sold in the year of assessment 2018/2019 for Rs.250,000 the adjustments would be as follows:

Depreciation allowed at 20%	Rs
2015/2016	120,000
2016/2017	120,000
2017/2018	120,000
Total depreciation allowed	360,000

As the lorry is sold in 2018/2019, no depreciation allowance was claimed for 2018/2019. The written down value (i.e., cost - total depreciation allowed) for tax purposes is Rs.240,000 - (Rs.600,000 - 360,000).

Profit on sale = Sales proceeds – Tax written down value

= Rs.250,000 – Rs.240,000

= Rs.10,000

Thus in the computation, the book entry for profit on sale should be cancelled and Rs.10,000 should be added to arrive at the income from business.



Example (iii): Disposal of assets- under the IR Act, No.24 of 2017

Assume that the assets which have been used in the business are sold in the year of assessment 2019/2020

Description	Year of purchased	Cost LKR	Capital allowances claimed LKR	Tax WDV LKR	Sale proceeds LKR	Taxable profit /Loss or Balancing allowance or assessable charge LKR
Lorry	2018/2019	3,000,000	600,000	2,400,000	3,200,000	800,000 assessable charge [sale of a depreciable asset Section 6(2)(d)]
Land	2018/2019	3,000,000	N/A	-	5,000,000	2,000,000 [sale of a capital asset is a business profit (6(2)(c)]
Machinery	2018/2019	3,000,000	600,000	2,400,000	1,500,000	(900,000) (Balancing allowance)

5.4.12 Disposal of Lease-hold assets purchased prior to 01st April 2018

If a lessee has acquired an asset under a lease agreement and used by him in his trade, business, profession or vocation even after the termination of the lease agreement , such asset is not qualified for allowance for depreciation as mentioned in section 25(7)(f)(vii) of the Inland Revenue Act, No. 10 of 2006. Further, such asset is treated as an asset on which full depreciation has been allowed to the lessee to the extent of the repayment of the capital value of such asset.

When the lease asset is sold whether such sale is upon the termination or not, it is subject to tax as provided in section 25(7)(f)(vi) of the said Act. It says, if a person has obtained an asset under a lease agreement and the lease rentals have been allowed as an expenditure, the receipts from the disposal of such leased assets (whether acquired directly or through nominees) shall be treated as a receipt of the business after deducting cost of acquisition other than the lease rentals allowed.

5.4.13 Disposal of Lease-hold assets purchased after 01st April 2018

Since lease assets are qualified to be claimed for capital allowance, tax treatment is similar to the tax treatment applicable for assets on which depreciation is claimable .

5.4.14 Special provisions

5.4.14.1 Disclaim of any income to be received or write off a debt as bad

- When an accrual basis is adopted in calculating the income of a person, he includes an amount as income whether received or receivable. However, later if he disclaims the entitlement to receive the amount or he writes off the debt as bad debt, section 24 specifically says that he can deduct the amount disclaimed or written off if he takes reasonable steps in pursuing the amount and the person reasonably believes that the entitlement or debt claim will not be satisfied.
- If any amount written off is allowed to be deducted and later recovered, that amount is required to be included for the period in which it is recovered.

5.4.14.2 Specific provisions on reversal of amounts already deducted

- When an accrual basis is adopted in calculating the income of a person, he deducts an amount of expenditure incurred as he is obliged to pay such amount. However, later if he disclaims the obligation to incur the expense, he is required to include such disclaimed amount as income for the period in which the disclaim is made.

5.4.14.3 Realization of a debt claim

- A debt claim owned by a person in relation to an asset and later such debt claim is written off as bad after taking reasonable steps in pursuing the debt claim and believing that debt claim will not be satisfied, it will be considered as realization of an asset.

“**Asset**” is defined in section 195 to say that it includes a tangible or intangible asset, currency, goodwill, know-how, property, a right to income or future income, a benefit that lasts longer than twelvemonths and a part of an asset.

5.4.15 Special provisions in section 10

- Deductions are explained from section 11 to section 19. When deducting certain expenses, the payer is required to deduct withholding tax as withholding agent. Section 10 (2) has specifically mentioned that where a person is allowed a deduction for a payment from which the person is required to withhold tax under withholding provisions, the deduction shall not be allowed until the tax withheld has been paid to the Commissioner-General.
- Section 10(3) says, no deduction shall be allowed except as expressly permitted by this Act.
- Section 10(4) says where more than one deduction applies, the most specific deduction shall be applied even if that results in the denial of a deduction.

5.4.16 Loss or unrelieved loss from Business income

In calculating the person's income from the business for a year of assessment, there could be a loss due to the excess of amounts deducted under the Act over the amounts included in calculating that income. When the loss that has not been deducted in calculating a person's income, it is known as unrelieved loss.

5.4.16.1 Business Losses – Section 19

In calculating the income of a person **from a business**, the following should be deducted:

–

- (a) an unrelieved loss of the person for the year from **any other business**; and
- (b) an unrelieved loss of the person for any of the **previous six years** of assessment **from the business or any other business**.

Unrelieved losses from a business may be deducted in calculating income from an investment;

Where a person makes a loss and if the loss were a profit it would be taxed at a **reduced rate**, the loss should be deducted only in calculating income taxed at the **same reduced rate**, a lower reduced rate or exempt amounts. If the loss were a profit and the profit would be **exempt**, the loss should be deducted only in calculating **exempt** amounts.

If enhanced capital allowance claimed as per second schedule result in an unrelieved loss for a person, it can be carried forward for 10 years.

If the investment is more than USD 1000 million or entitled to enhanced capital allowance on investing more than 250 million on assets or shares of a government owned undertaking, and if results an unrelieved loss, it can be carried forward for 25 years.

5.4.16.2 Losses on Realization of Business Assets and Liabilities

- In calculating a person's income from a business for a year of assessment, a loss of the person from the realization of capital assets and liabilities should be calculated based on the provisions in Chapter IV of the Act, and
- With regard to capital assets, to the extent to which the assets were used in the production of income from the business, and
- In the case of Liabilities that is a debt obligation incurred in borrowing money, the money was used or an asset purchased with the money was used in the production of income from the business, and
- In the case of any other liability, the liability was incurred in the production of income from the business.

5.4.16.3 Transitional Provisions on Losses

Any unabsorbed loss available as at 31st March 2018 under the Inland Revenue Act, No. 10 of 2006 is deemed to be a loss for the year of assessment commencing on or after April 1, 2018 under the Inland Revenue Act, No. 24 of 2017 and be deductible in accordance with the Inland Revenue Act, No. 24 of 2017. Such unabsorbed loss could be claimed subject to the maximum of six years.

6.0 Calculation of Assessable income from investment

6.1 What is Investment Income?

Investment income is received from investment. Investment means the owning of one or more **assets**, including one or more assets of a similar nature or that are used in an **integrated fashion**, and includes a past, present or prospective investment or a game of chance, including lotteries, betting or gambling, but excludes a business or employment.

“asset” is defined in the Act to say that it includes a tangible or intangible asset, currency, goodwill, know-how, property, a right to income or future income, a benefit that lasts longer than twelve months and a part of an asset.

Under the Inland Revenue Act, No.24 of 2017, following income falls under the investment income.

- dividends, interest, discounts, charges, annuities, natural resource payments, rents, premiums and royalties;
- gains from realization of investment assets (namely capital gains);
- amounts derived as consideration for accepting a restriction on the capacity to conduct the investment;

- **Gifts** received in respect of investments;
- Winning from lotteries, betting or gambling;
- other amounts required to be included under this Act.

Investment asset means, a **capital asset** held as part of an investment but excludes the principal place of residence of an individual if such asset is owned by the individual continuously for three years before the disposal and lived in for at least two of those three years (calculated on a daily basis).

Capital asset is also defined as follows.

“capital asset” means each of the following assets but excludes trading stocks and depreciable assets:

- (i) land or buildings;
 - (ii) a membership interest in a company (i.e. shares), partnership or trust;
 - (iii) a security or other financial asset;
 - (iv) an option, right or other interest in an asset.
- Investment income is subject to withholding tax, and there are certain rules applicable for payer of the income and the recipient of the income as withholding agent and withholder respectively. (Refer Chapter 7 for more details on withholding tax).

6.2 Categories of Investment Income

6.2.1 Dividend income

Dividend is defined in the Act as follows.

- a payment derived by a member from a company, whether received as a division of profits, in the course of a liquidation or reconstruction, in a reduction of capital or share buy-back or otherwise,
- a capitalization of profits whether by way of a bonus share issue, increase in the amount paid-up on shares or otherwise; and
- a capitalization of profits whether an amount is distributed or not.

However, it excludes a payment to the extent to which it is

- matched by a payment made by the member to the company
- debited to a capital, share premium or similar account; or
- otherwise constitutes a final withholding payment or is included in calculating the income of the member.

6.2.2 Dividend tax

- Dividends distributed by a resident company is taxed on the company's shareholders. In other words, the shareholders are liable for income tax on such dividend income.

- However, companies are required to deduct withholding tax at the rate of 14% from the gross dividends as the withholding agent, other than on dividends paid out of dividends received from other resident companies and remit to the Department of Inland Revenue.
- Such dividends will not be considered as a part of the assessable income of a resident person, and the dividend paid is a final withholding payment.

6.2.3 Income from interest

Interest is defined in the Act as follows.

“**interest**” includes –

- a payment, including a discount or premium, made under a debt obligation that is not a repayment of capital; and
- a swap or other payment functionally equivalent to interest
- a commitment, guarantee or service fee paid in respect of a debt obligation or swap agreement; and
- a distribution by a building society.

6.2.3.1 Applicable withholding provisions on Interest or discount

- Interest or discount is subject to withholding tax at the rate of 5%.
- However, if it is paid to a senior citizen in relation to a bank deposit, up to Rs.1.5 million is not subject to withholding tax. **Senior citizen means** an individual who is a resident, a citizen of Sri Lanka and over sixty years during the year of assessment.
- In the hands of a resident individual, interest income is treated as final withholding tax payments. Therefore, such individuals are not required to disclose such income to the assessable income and not entitle to claim any tax credit for such taxes withheld.
- Interest paid to non-residents is subject to withholding tax at the same rate of 5% and in the hands of any recipient it is treated as final withholding payment unless such interest is derived through a Sri Lankan permanent establishment which is defined in section 195.
- However, the following interest payments are not liable to withholding tax:
 - Payments made by individuals, unless made in conducting a business
 - Interest paid to a financial institution on the ordinary loans and advances provided by it.

- Any interest payment is not subject to withholding tax due to the payer is an individual who is not conducting a business, or the payer is non-resident, then such interest income is liable to income.

6.2.4 Charge

- A charge is a sum received by a person arising out of a deed or the result of a court order, which is secured, on the income of any property of the payer.

6.2.5 Rent

“Rent” is defined in the Act as follows.

- (a) Rent means a payment, including a payment of a premium or like amount for the use of or right to use a property of any kind;
- (b) includes a payment for the rendering of, or the undertaking to render, assistance ancillary to a use or a right referred to the above paragraph (a), but
- (c) excludes a natural resource payment or a royalty.

- When rent is paid to a resident person, WHT is to be deducted at 10%. Since this is not final withholding tax, the rent payment is subject to further tax as follows and withholding tax so deducted is entitled for a credit.
- In the case of an individual with rental income from an investment asset, an amount of 25% of the total rental income for a year of assessment is granted. This is for a relief for the repair, maintenance and depreciation relating to the investment asset.
- However, the individual is maintaining proper books to claim actual expenses incurred for repair and maintenance, in such situation the above mentioned 25% relief is to be adjusted.
- When the rent is paid to a non-resident, WHT is to be deducted at the rate of 14%. Thereafter, it will be treated as a final withholding payment unless it is derived through a permanent establishment.

6.2.5.1 Premiums

- A premium is a payment for the right to use a property over and above the payment for actual use. For example, key money received from letting a commercial property.
- When premium is paid, it is subject to WHT at 14%. In the hands of residents, WHT credit can be claimed whereas in the hands of non-residents, it is treated as final.
- In the hands of the payer, it is treated as an intangible asset, and capital allowance can be claimed for the number of years of the actual useful life of the intangible asset or where the intangible asset has an indefinite useful life, then it is 20 years.

6.2.6 Annuity

- Annuity means a fixed sum receivable annually which is not a capital nature. The payment of an annuity which should be made with reference to a year may be in periodic installment.
- Annuity is exempt, if it is derived by a senior citizen from an annuity for life for a period of not less than ten years purchased from a bank or an insurance company.

6.2.7 Royalty

- As to the definition in the Act, “**royalty**” means a payment, including a payment of a premium or like amount, derived as consideration for–
 - the use of or right to use a copyright of literary, artistic or scientific work, including cinematograph films, software or video or audio recordings, whether the work is in electronic format or otherwise;
 - the use of or right to use a patent, trade mark, design or model, plan, or secret formula or process;
 - the use of or right to use any industrial, commercial, or scientific equipment;
 - the use of or right to use information concerning industrial, commercial or scientific experience;
 - the rendering of or the undertaking to render assistance ancillary to a matter referred to in paragraph (a), (b), (c) or (d); or
 - a total or partial forbearance with respect to a matter referred to in paragraph (a), (b), (c), (d) or (e).
- Royalty payment is subject to withholding tax at 14%, and WHT credit for residents is available. It is considered as Final withholding payment in the hands of a non-resident unless it is derived through a Permanent Establishment (PE).

6.2.8 Gifts received by the person in respect of the investment

- This seems to be a new feature incorporated to the New IR Act. Gift is defined in the Act as follows.

“gift” means a transfer without consideration or a transfer with consideration to the extent that the market value of the property exceeds the market value of the consideration.

6.2.9 Winnings from lotteries, betting or gambling

- Winnings from lotteries, betting or gambling are specifically deemed to be income from an investment. However, no deduction is allowed for amounts incurred on lotteries, betting or gambling under s. 10(a) (IX). This prohibition against deduction does not apply to amounts incurred from conducting a business of gambling.
- As per the Third Schedule, any winning from a lottery, the gross amount of which does not exceed Rs.500,000 is exempt. Therefore, up to that amount WHT is not applicable. Otherwise, the receipts by winning from lotteries, rewards, betting or gambling is subject to WHT at 14%. Thereafter, it is treated as final withholding payment irrespective of such person is a resident or non-resident.

- Income Tax should be paid by an individual who has a taxable income and who receives final withholding payments.
- Income Tax is paid on income from employment, business, investment and other sources.
- The Year of Assessment is the period of 12 months commences from 01st April of an year and ending on 31st March of the following year.
- Income Tax is calculated on rates specified in the First schedule to the Act.
- Resident individuals are liable for Income Tax on their world income.
- Non-resident individuals are liable for Income Tax only on the income arises in or is derived from a source in Sri Lanka.
- The assessable income of an individual from employment includes all the benefits received, whether in cash or otherwise.
- Value of non-cash benefit is to be determined based on the market value or value placed by the Commissioner General.
- Some of the employment income is exempt from tax.
- Employers are required to deduct income tax based on PAYE Tables specified by the Commissioner General.
- Accounting profit needs to be converted into profit for tax purposes using adjustments.
- The general rule is that all expenses incurred in the production of income are allowed as deductions. However, there are certain deductions specifically allowed as well as specifically disallowed.



Taxation of a resident individual

Mangala Karunanayake is a Chartered Engineer working since 2010 for a construction company in Sri Lanka. The following information relating to his income is available for the Y/A 2018/19.

Employment Income

- Basic Salary Rs.280,000 per month
- Contribution to the approved provident fund is 8% and the employer's contribution to this fund is at 12% on the basic salary.
- The employer undertakes the lease rental payable on a lease agreement entered into by Mr. Mangla on his motor vehicle. Lease rental per month is Rs.45,000, and during this year of assessment nine rentals have been paid by the employer.
- Mr. Mangala has rented out a residence for him in August 1, 2018 and rent payable per month is Rs.40,000. It has been paid by the employer.
- Tax on employment income - deducted tax under PAYE Scheme Rs.337,000

Professional Income

- Mr. Mangala provides engineering consultancy services to few other companies in Sri Lanka as an independent professional, and received consultancy fee. The amount received in cash after deducting withholding tax at 5% is Rs.475, 000. He has deducted expenditure for tax purpose amounting to Rs.123,000.
- He also provided consultancy service to a hotel in Maldives being in Sri Lanka, and the net amount received in foreign currency is 1460. 1 US\$ equals to Rs.169 as at the end of the year of assessment.

Business Income

- Mr. Mangala is running an educational establishment as a proprietorship for students who do advance level examination in science stream.

The following is a summary of the income statement prepared for the year ended 31 March 2019.

	Rs.
Total receipts	6,230,000
Less:	
Fees paid to lecturers	1,442,000
Salaries and wages	600,000
Stationery	240,000
Book depreciation	50,000
Utility Bills	110,000

Interest	272,000
Donation	50,000
Other expenses	60,000
Net profit	3,406,000

- Computer used in the establishment was purchased during the year of assessment 2016/17 and its cost is Rs.100,000. Printer purchased during the year of assessment 2018/19 is Rs.75,000. There are no other qualifying assets on which allowances for depreciation are claimable.
- Interest was paid on a housing loan which has been taken to construct a house for his daughter.
- Donation of Rs.50,000 was made to the General hospital Rathnapura.

Income from Investments

- Net interest received from a fixed deposit in a bank is Rs.95,000.
- Net dividend received from companies is Rs.24,000.
- He has earned profits on sale of shares in listed companies amounting to Rs.11,000.
- Net rent received from a company is Rs.864,000 on a building which has been constructed out of a loan. In this regard he has paid Interest amounting to Rs.210,000. Repair cost incurred is Rs.14,000. The Rating Assessment of the building is Rs.100,000, and the rates are paid by Mr. Kalum is at 20%.
- Sold a building for Rs.3,600,000 which was purchased in 2010 for Rs.1,800,000. The value of the property as at September 30, 2017 is Rs.3,000,000. Capital gain return has been furnished after making the due tax payment.

Mr. Mangala has made the following payments.

- Cash donation made to an approved charitable institution providing institutionalized care for sick and needy of Rs. 40,000.
- Tax paid on self-assessment is Rs.500,000.

Answer

Employment income		
Salary 280,000 x12		3,360,000
Contribution to fund by employer is not subject to tax 280,000 x 12% x 12	403,200	
Lease rental on a motor vehicle 45,000 x 9		405,000
Rent paid for the residence 40,000 x 8		320,000
Employment income		4,085,000
Professional income		
Net fee income 475,000/95 x100 - 123,000		377,000
From Maldives 1460 X 169		246,740
Business		
Net profit	3,406,000	
Add :book depreciation	50,000	
Interest - domestic expense	272,000	
Donation	50,000	
Less capital allowance		
Computer purchased prior to 01.04 2018 100,000 x 25%	(25,000)	
Printer 75,000 /5	(15,000)	
Adjusted profit	3,738,000	3,738,000
Investment income		
Net interest - WHT deducted - final withholding payment	95,000	-
Net dividend - WHT deducted final Withholding payment	24,000	
Profit from sale of shares - exempt	11,000	
Rent income 864,000 / 90 x 100 less interest paid 210,000 and rates paid 20,000		730,000
Capital gain consideration less value as at 30.09.2017. 3,600,000 - 3,000,000		600,000
Total Assessable income		9,776,740
Tax free allowance		(500,000)
Relief for employment		(700,000)

Relief for rent income - 25 % for repairs 960,000 x 25%		(240,000)
Consultancy income in foreign currency		(246,740)
Allowance for qualifying payments:		
Cash Donation to approved charity which provides institutional care for sick and needy: 40,000 1/3 of the taxable income or 75,000 whichever is lower		(40,000)
Donation to general hospital 100% claimable		(50,000)
Taxable income		8,000,000
Income tax payable		
Capital gain 600,000 x 10%	60,000	
First 3,000,000	360,000	
Balance 4,400,000 x 24%	1,056,000	
Total tax payable	1,476,000	
Less tax credits		
PAYE	(337,000)	
WHT 5% on professional fee	(25,000)	
WHT 10% on rent income	(96,000)	
Tax on capital gain	(60,000)	
Installment payment	(500,000)	
Balance payable	458,000	

Basic Income Tax Liability of a Resident Company

Knowledge Component

C Basic Income Tax Liability of a Resident Company

- | | |
|--|---|
| 3.1 Basic understanding of income tax liability of a resident company (non-complex straightforward scenario) | 3.1.1. Identify various types of companies in relation to application of different rates of income tax. |
| | 3.1.2. Explain specific adjustments applicable to the computation of Assessable income of a company from business (other than adjustments applicable to intercompany transactions). |
| | 3.1.3. Compute taxable income of a company, by making relevant statutory deductions. |
| | 3.1.4. Compute income tax payable by a small or medium sized company. |
| 3.2 Basic Transfer Pricing | 3.2.1 Identify the concept of arm's length price. |
| | 3.2.2 State documentation requirements under transfer pricing regulations. |

CHAPTER CONTENTS

1. Basic understanding of income tax liability of a resident company
2. Basic Transfer Pricing

LEARNING OUTCOME

3.1.1, 3.1.2, 3.1.3, 3.1.4
3.2.1, 3.2.2

1. Basic understanding of income tax liability of a resident company (non-complex straightforward scenario)

1.1 Types of companies for taxation purposes

Resident and non-resident companies are taxed under different models.

In Sri Lanka, companies are registered or re-registered under the Companies Act, No. 07 of 2007.

Although there are different types of companies under the Companies Act, the following categorizations are recognized for taxation purpose.

Resident companies

If a company is incorporated or formed under the laws of Sri Lanka or has its registered or principal office in Sri Lanka or its management and control of the affairs of the company are exercised in Sri Lanka, such company is considered as a resident company in Sri Lanka.

Resident companies are liable to income tax on their global income.

Non-resident companies

Any company which does not come under the above rules (resident company) would be considered as a non-resident company.

The non-resident companies are liable to tax on income, gains and profits arising in or derived from a source in Sri Lanka.

1.2 Taxable Income

The taxable income of a company for a year of assessment is calculated by deducting **qualifying payments** from the **total assessable income** of a company.

Taxable Income = Total Assessable Income - qualifying payments

1.2.1. Qualifying payments

An allowance for qualifying payments can be deducted from assessable income in arriving at the taxable income subject to certain limitations.

- a) A donation made by a company in money to an approved charitable institution established for the provision of institutionalized care for the sick or the needy and declared by the Minister as an approved charitable institution is claimable subject to 1/5 of the taxable income or Rs.500,000 whichever is lower. Unclaimed amount, if any, cannot be carried forward.
- b) 100% deduction is available on donation made in money or otherwise to the government including the following institutions:
 - a local authority;
 - any Higher Education Institution established under the Universities Act or Buddhist and Pali University of Sri Lanka or any Higher Educational Institution established under the Buddhist and Pali University of Sri Lanka Act,
 - a fund established by the Government of Sri Lanka
 - a fund established by a local authority or by a Provincial Council and approved by the Minister;
 - the Sevana Fund of the National Housing Development Authority
 - the Api Wenuwen Api Fund
 - National Kidney Fund;
- c) Profits remitted to the President's Fund by a public corporation as required by the law by or under which such corporation is established.

1.2.2 Transitional provision on qualifying payments

As per the transitional provisions mentioned in the transitional gazette notification No. 2064/53 dated April 1, 2018, any balance of qualifying payments as at March 31, 2018 which has been claimed as per section 34 of the Inland Revenue Act, No. 10 of 2006 is deductible as an allowance in ascertaining the taxable income of any person for any year of assessment commencing after April 1, 2018 subject to any conditions specified in the provisions enabling such deductions.

1.3 Total Assessable Income

The total assessable income of a company for a year of assessment is the aggregate of following elements:

- Assessable income from business
- Assessable income from investments
- Assessable income from any other source

1.4 Assessable Income from business

The amounts to be included and excluded in calculating an assessable income from business of a company for a year of assessment is based on section 6 of the Act. The assessable income from business is computed after taking into account the deduction rules provided in section 10 to section 19 of the Inland Revenue Act as similarly to the calculation of assessable income from a business of a sole proprietorship. Please refer to the discussion in **Chapter 2**.

An important point to keep in mind is an investment income sometimes could be considered as business income based on the facts where such investment income is effectively connected to the business.

Apart from such deduction rules, the restriction on deduction of financial cost provided in section 18 is applicable for an entity.

1.4.1 Financial Cost - Thin Capitalization

This is applicable to business or investment income of an **entity**** other than a financial institutions.

The amount of financial cost attributable to the financial instrument is to be limited to the formula: **"A x B"**

"A" = total issued share capital+ reserves other than revaluation reserves

"B" = number 3, for manufacturing entities number 4, for any other entity

Any residue of the financial cost that could not be deducted in a year, can be carried forward for six years applying the same formula.

******This thin capitalization rule applies to an entity. As to the definition given to 'entity', a company, partnership or trust falls to the term 'entity'. However, you must note that, the above formulae can be applied where a share capital exists only.

Financial instrument is defined in section 198, and it covers any interest payable on the debt obligations including accounts payable and obligation arising under deposits, debentures, stocks, treasury bills, promissory notes, bills of exchange and bonds any derivative instrument or foreign currency instrument. It appears that overdraft also is covered.

1.5 Assessable Income from investment

Investment income for a company for a year of assessment is profits and gains from an investment for the year. The items covered under the investment are listed in the section 7 of the Inland Revenue Act.

Calculation of assessable income from other investment income, is similar to the calculation of assessable income from investment income of individuals. Please refer **Chapter 2**.

For your study purpose we will consider following investment income in detail:

- Interest income
- Dividend income
- Rent income

1.5.1 Interest income

Interest income includes interest arising from various deposits held at banks and financial institutions, investments such as debentures and treasury bills, and loans granted. When the interest is paid, it is subject to withholding tax. However, withholding tax is not applicable on interests paid to any person on government securities and interest payable to any financial institutions on the ordinary loans and advances given by the bank. Otherwise, interest is subject to withholding tax at the rate of 5%.

For companies, withholding tax is deducted from interest is not a final tax. Thus, in the event that net interest is accounted, it should be grossed up in arriving at assessable income.



Calculation of Gross interest income

$$\text{Gross Interest income} = \text{Net interest income} \times \frac{100}{95}$$

$$\text{Gross interest income} = \text{Net interest income} + 5\% \text{ of WHT}$$

Example: Interest income

The net interest income of a company as per the income statement is Rs.9,500. Accordingly, the gross interest income should be Rs.10,000. (i.e. Rs.9,500 x 100/95).

Since the **withholding tax** is deducted on interest income is **not a final tax**, gross interest income is subject to further tax at the rate applicable to that company.

Withholding tax deducted at source can be claimed as a credit against tax payable.

Interest income received by a licensed commercial bank in Sri Lanka from Sovereign Bonds denominated in foreign currency is **exempt** from income tax.

1.5.2 Dividend

The dividend income is defined as final withholding payment as per section 88 of the Act. Therefore, the dividend is not an investment income liable for tax.

As per the transitional gazette notification, a dividend received from another resident company where 10% dividend tax has been deducted is considered as final withholding payment if it is distributed prior to 31st March 2019. The dividend paid out of dividend received from another resident company where withholding tax at 14% had been deducted, then such dividend is exempt from income tax as per third schedule.

Furthermore, dividends received from a foreign company by a resident company from share investment made in a nonresident company which is not less than 10% of value of shares excluding redeemable shares of such company and has a control over such nonresident company either directly or indirectly of 10% or more of the voting power in such nonresident company are also exempt from taxation in Sri Lanka.

1.5.3 Rent

Rent income from any kind of property which has been given to use of or to right to use is considered as investment income, and expenditure incurred in producing such income can be deducted. However, in the case of repairs and improvements, revenue nature expenditure can be deducted but not the capital nature expenditure. Therefore, it could be considered as part of the cost of the asset. However, based on the facts, sometimes rent could be treated as income from business if such rent income is effectively connected to the business. In such a case, actual expenses for repairs and improvements can be claimed subject to a ceiling given in section 14 of the Act. Due to the restriction, if there is any unabsorbed amount, it can be carried forward to the subsequent year of assessment, and capital allowance can be claimed.

Calculation of assessable income from other investment income, is similar to the calculation of assessable income from investment income of individuals. Please refer **Chapter 2**.

1.6 Calculation of Tax liability

Gross income tax liability of a company is computed on the **taxable income** of the company for a year of assessment. There is a standard income tax rate of 28% and in addition tax rates of 14% and 40% are applicable for certain companies.

$$\text{Tax liability} = \text{Taxable Income} \times \text{Income Tax Rate}$$

1.7 Tax Rates applicable to companies with effect from the year of assessment 2018/2019

Type	Rate
Standard rate applicable to company	28%
Concessionary tax rate	14%
Rates on a company with income from a business consisting of betting and gaming, liquor and tobacco (excluding such income which is merely incidental to another business)	40%

1.7.1 Concessionary tax rate of 14%

- a) **A Small and Medium Enterprise, which** conducts business solely in Sri Lanka and does not have an associate that is an entity and its annual gross turnover is less than Rs.500,000,000 is chargeable to tax at 14% rate.

As defined in the Act, a person and an entity are associated persons when the person controls the entity or may benefit from fifty percent or more of the rights to income, capital or voting power of the entity either alone or together with persons who are associated with the person whether directly or through one or more interposed entities.

Accordingly, a company which is a small and medium enterprise and has an associate as explained above is not qualified for 14% tax rate.

- b) A company having more than 80% (predominantly) from conducting a business of exporting goods and services is entitled to the 14% rate.

Export is defined to include specified undertakings. Then again, specified undertakings is defined to include the following.

- Entrepot trade involving import, minor processing and re-export
- Offshore business where goods can be procured from one country or manufactured in one country and shipped to another country without bringing the same into Sri Lanka
- Providing front end services to clients abroad.
- Headquarter operations of leading buyers for management of financial supply chain and billing operations
- Logistics services such as bonded warehouse or multi – country consolidation in Sri Lanka
- Transshipment operations
- Freight forwarding
- Supply of service to any exporter of goods or services or to any foreign principal of such exporter directly, being services which could be treated as essentially related to the manufacturing of such goods or provisions of such service exported by such exporter either directly or through any export trading house, including any service provided by an agent of a ship operator to such agent's foreign principal, and the payment of such services are made by such exporter or foreign principal to such person in Sri Lanka in foreign currency.

- Production or manufacture, and supply to an exporter of non-traditional goods
 - Performance of any service of ship repair, ship breaking repair and refurbishment of marine cargo containers, provision of computer software, computer programs, computer systems or recording computer data, or such other services as specified by Minister by noticed public in the Gazette.
 - Sale for foreign currency of gem or jewelry by any person approved by CBSL
- Accordingly, any of these companies, which do above business, is entitled to the 14% tax rate subject to the fulfillment of predominantly concept
- c) A company having more than 80% of the gross income (predominantly) from conducting an agricultural business.
- d) A Company having more than 80% of the gross income (predominantly) from providing educational services.
- e) A Company predominantly engaged in an undertaking for the promotion of tourism. “Undertaking for the promotion of tourism” is defined as follows:

An undertaking for the operation of-

- i. Any hotel or guest house approved by the Ceylon Tourist Board;
 - ii. any restaurant graded by the Ceylon Tourist Board as being in “Class A” or “Class B”;
 - iii. Any business of travel agent who provides travel management services for domestic travel in Sri Lanka;
 - iv. Any business of transporting tourists only; or
 - v. Any business approved by the Ceylon Tourist Board for providing facilities for recreation or sports;
- f) Company having more than 80% of the gross income from providing information technology services is chargeable to 14% tax.

Information technology service means software development services or the provision of information technology services under a business process outsourcing arrangement or a knowledge process outsourcing arrangement.

1.8 Transitional provisions

1.8.1 Transitional provisions on tax rates under the Inland Revenue Act, No. 10 of 2006

If any company is entitled to pay tax at concessionary rate under sections 59D ,59I ,59J ,59K ,59L ,59M of the Inland Revenue Act, No.10 of 2006, and, if there is any unexpired part of that period as at 31st March 2018, such rate can be continued to be applied for a period as specified in those provisions

1.8.2. Tax exemptions under the Inland Revenue Act

As per the transitional provision in the gazette notification, any unexpired part of tax exemption period as at March 31, 2018, can be continued if such exemption has been granted, under sections 16C ,16D ,16E ,17 ,17A ,18 ,20 ,24A, of the Inland Revenue Act, No.10 of 2006. Accordingly, the whole or any part of the profits and income of a person is continued to be exempt from income tax for a period specified in those provisions.

1.8.3. Tax exemptions granted by the BOI

Any tax exemptions or profits and income taxable at reduced rate granted by the BOI based on the agreement entered into with an enterprise prior to 01st April 2018 on its profits and income and dividend paid and if the agreement provides for the profits and income of that enterprise and the dividend payment to be fully or partly exempt from income tax, profits and income taxable at reduced rate under the previous Inland Revenue Acts No. , No. 28 of 1979 or No. 38 of 2000 or No. 10 of 2006 as the case may be, such concessions can be continued to be applied.



Example: Computation of tax on taxable income (i)

Araliya Suppliers Ltd is engaged in the business of import and supply of printing materials. This company does not have any associates.

Required:

Calculate the income tax payable for the Y/A2018/2019 under each situation given below.

- a) Annual gross turnover is Rs.347,850,000, and taxable income is Rs.15,141,000
- b) Annual gross turnover is Rs.672,732,000, and taxable income is Rs.34,657,000

Suggested working:

- a) Annual gross turnover does not exceed Rs.500m. Therefore, the rate of tax is 14%.

$$\text{Rs.15,141,000} \times 14\% = \underline{\text{Rs.2,119,740}}$$

- b) Annual gross turnover exceeds Rs.500m. Therefore, the rate of tax is 28%.

$$\text{Rs.34,657,000} \times 28\% = \underline{\text{Rs. 9,703,960}}$$



Example: Computation of tax on taxable income (ii)

The taxable incomes of the three companies in the Ratmale Group of Companies for the Y/A 2018/2019 are given below. All the companies are engaged in manufacturing activities and annual gross turnover of all three companies remained below Rs.500m for the year.

Ratmale Ltd – Parent Company	Rs.8,000,000
Ratmale Cosmetics Ltd–Subsidiary Company	Rs.2,000,000
Ratmale Logistics Ltd.–Associate Company	Rs. 100,000

Required:

Calculate the tax payable on the taxable income of each company for the Y/A 2018/2019.

Suggested working

Company	Taxable income (Rs.)	Tax rate	Rs.
Ratmale Ltd	8,000,000	28%	2,240,000
Ratmale Cosmetics Ltd	2,000,000	28%	560,000
Ratmale Logistics Ltd	100,000	28%	28,000

Explanation: Being an associate, tax is calculated at 28%. Although the turnover of each company is less than Rs.500M, the concessionary rate (14%) under the 1st schedule is not applicable to companies in the group.



Example: Computation of tax on taxable income (iii)

SCIS (Pvt) Ltd owns SCIS International School in Colombo. The taxable income of the company for the Y/A 2018/2019 is Rs.10,000,000, and it includes Rs.1,000,000 interest from call deposits made in banks.

Required:

Calculate the tax payable on taxable income.

Suggested working		
Tax payable for the year On taxable income	10,000,000 x 14%	1,400,000

Assume the company predominately engaged in providing educational services, hence, it is taxable at 14%.

1.9 Tax credits and calculation of income tax payable

The following tax credits can be deducted in determining the income tax payable.

- Withholding tax on interest deducted by financial institutions
- Any other withholding taxes on the income which forms part of taxable income
- Income tax paid on self-assessment basis
- Economic Service Charge (ESC) paid / brought forward
- Notional tax credit on interest on Treasury Bills / Treasury Bonds can be claimed subject to the restriction explained below.

1.9.1 Transitional provision on notional tax credit

As per the IR Act, interest paid on Treasury Bills or Treasury Bonds, no withholding tax is collected at the point of issue of these securities. Hence, there cannot be any notional tax credit to be claimed on investments made after April 1, 2018.

However, as per the transitional gazette notification, on any unabsorbed notional tax credits as at 31st March 2018 which has been carried forward as per section 138(2) of Inland Revenue Act, No.10 of 2006 can be claimed to be set off against the income tax liability. However, it should be claimed within three consecutive years of assessment commencing from the year of assessment 2018/2019.



Example: Computation of income tax payable

The Statement of Income of ABC (Pvt) Ltd which is in the business of manufacture of food products for the Y/A 2018/2019 is as follows:

	Rs.
Turnover	300,000,000
Net profit after following income/expenses	6,000,000
Income:	
Net dividend from resident companies	1,000,000
Net interest from Banks	285,000
Net Interest on treasury bills	540,000

Expenses:	
Entertainment	100,000
Director's emoluments	3,000,000
Book depreciation	1,200,000
Royalties paid	500,000
Donation to government	200,000
Donation to an approved charity	600,000
Fine paid to the government	10,000
Bad debt provision	630,000

Notes:

- i. Full depreciation has been claimed on all the assets purchased prior to April 1, 2018 other than the building constructed in 2016 at a cost of Rs.5 million.
- ii. A machinery purchased for Rs.3 million in August 2018 was used in the production of income.
- iii. On royalty payment, withholding tax has been deducted and remitted to the CGIR.
- iv. A donation has been made to a charitable institution where sick and needy people are maintained in the institution itself.
- v. Fine was paid to the government on breach of law.
- vi. Though a provision has been made on bad debt, no reasonable action has been taken to recover it.
- vii. Tax loss brought forward from the Y/A 2017/2018 is Rs.500,000.
- viii. The company has made a self-assessment tax payment of Rs.500,000 for the year.

Required:

Calculate the income tax payable by ABC (Pvt) Ltd for the Y/A 2018/2019.

Suggested working

Adjustment of net profit for tax purposes (Amounts in rupees)	+	-
Profit before tax	6,000,000	
Dividend received : does not form a part of Assessable Income as it is a final withholding payment		1,000,000
Interest from banks		285,000
Interest on treasury bills (non-business income)		540,000
Add:		
Disallowable expenses		
Entertainment	100,000	
Depreciation	1,200,000	
Royalty paid is allowed since WHT has been remitted		
Fine paid	10,000	
Bad debt provision is not allowed	630,000	
Donations (600,000 + 200,000)	800,000	
Less; Allowance for depreciation on building (5,000,000 x 10%) As per transitional provisions gazette		500,000
Allowance on depreciation on the		

machinery , class 2 asset, No. of years is five 3,000,000 /5		600,000
C/F loss is deductible under the transitional provisions		500,000
	8,740,000	3,425,000

Assessable income from business (adjusted profit) = Rs.8,740,000 – Rs.3,425,000
= Rs.5,315,000

Computation of taxable income	Rs.	Rs.
Profit from business (adjusted)		5,315,000
Interest from Banks (285,000 x 100/95)		300,000
Interest on treasury bills		540,000
Less: Deductions (Allowance for qualifying payments)		
Donation to government (100% claimable)	200,000	
Donation to approved charity Rs.600,000 (Allowance limited to 1/5 of assessable income or Rs.500,000, whichever is lower)	500,000	(700,000)
Taxable income		5,455,000

Profit from a manufacturing business of which turnover is less than Rs.500 million is taxable at 14%.

Therefore, the tax on taxable income is Rs.763,700 (5,455,000 x 14%).

Income tax payable

	Rs	Rs
Tax on taxable income		763,700
Less: Tax credits		
Self-assessment tax paid	500,000	
WHT on interest	15,000	
		(515,000)
Income tax payable		248,700

2. Basic Transfer Pricing

2.1 Arm's Length Price

According to the arm's length principal the price of a transaction between associate undertakings should be equal or closer to a price if such transaction entered into between an independent parties. For this purpose, both transactions (with associate and with independent party) are carried out on same terms and conditions

Therefore, to determining income, gain or profits or losses incurred in any transaction, operation or scheme entered into between two associated enterprises calculated in accordance with arm's length price.

2.2 Associate undertaking

A person shall be an associated enterprise of another enterprise, if one person participates directly or indirectly or through one or more intermediaries in the management, control or capital of the other person as may be prescribed.

2.3 Document requirement

The transfer pricing regulation issued under the Extraordinary Gazette No. 2104/4 dated 31 December 2018 require taxpayers to file a Transfer Pricing Disclosure Form (TPDF) along with the Income Tax Return which depend on the value of the transaction.

- Transaction related disclosures – such as category of transaction as per the list provided in **Annexure V** of the transfer pricing regulations and the amount.
- Associate Enterprise related disclosures– such as name, tax identification number, country of tax residence and the criteria of associated enterprise as per the list provided in the **Annexure VII** of the transfer pricing regulations.
- Transfer Pricing methodology related disclosures – such as transfer pricing method, profit level indicator, actual price/ profit margin / rate and the tested enterprise.
- Arm's length price related disclosures – such as comparable price / margin, upper limit, lower limit and median of the range.

**CHAPTER ROUNDUP**

- ↳ Resident and non-resident companies are taxed under different models.
 - Resident companies are liable to pay tax on taxable incomes and tax on final withholding payment.
 - Limits of qualifying payments available for companies are different than for
 - individuals. Self-assessment tax payments are required and it can be set off against the tax liability.
- Transactions between associate under taking should be on arm's length price.



PROGRESS TEST

- 1 The net interest income recorded in the bank statement of a company is Rs.95,000.
Calculate the gross interest income and the tax credit due.
- 2 **State** the corporate tax rate applicable to a company which is not having any associate company and having a turnover less than Rs.500 million.
- 3 A donation by a company to an approved charity for institutionalized care for sick and needy can be deducted:
 - A. Up to $1/5^{\text{th}}$ of the assessable income
 - B. Up to Rs.500,000**
 - C. **Up to Rs.500,000** or $1/5^{\text{th}}$ of the assessable income, whichever is lower
 - D. Rs.500,000 or $1/5^{\text{th}}$ of the assessable income, whichever is higher
- 4 **Identify** the tax credit which cannot be claimed by a company.
 - A. Self-assessment tax paid
 - B. Withholding tax on interest
 - C. Withholding tax on dividends
 - D. Notional tax credit

ANSWERS TO PROGRESS TEST

- 1 Gross interest income Rs.100,000 and Rs.5,000 would be the tax credit.
- 2 Since the turnover is less than Rs.500 million and having no associate, appropriate income tax rate is 14%.
- 3 Up to Rs.500,000 or 1/5 of the assessable income, whichever is lower.
- 4 Withholding tax on dividends

Gains from realisation of investment assets

Knowledge Component

D. Gains from realisation of investment assets

4.1 Imposition of tax on gains from realisation of assets & liabilities	4.1.1. Identify the history of capital gains tax in Sri Lanka. 4.1.2. State the consequences of non-compliance. 4.1.3. Identify investments assets.
4.2 Cost of an asset and consideration	4.2.1 Identify cost of an asset and incidental expenditure. 4.2.2 Identify the consideration received on realisation of asset.
4.3 Realisation of assets and liabilities	4.3.1 State points of realisation of assets and liabilities including reversal, refunds and compensation. 4.3.2 Identify realisation with retention assets. 4.3.3 Identify transfer of assets to spouse and former spouse, transfer on death, transfer to an associate for no consideration. 4.3.4 Identify involuntary realisation with replacement. 4.3.5 Identify involuntary realisation by separation.
4.4 Calculation of gains and losses	4.4.1 Calculate the gain or loss from realisation of assets & liabilities. 4.4.2 Explain the procedure for payment of tax on realisation of gains.

CHAPTER CONTENTS**LEARNING OUTCOME**

1. Imposition of tax on gains from realisation of assets & liabilities	4.1.1, 4.1.2, 4.1.3
2. Cost of an asset and consideration received	4.2.1, 4.2.2
3. Realisation of assets and liabilities	4.3.1, 4.3.2, 4.3.3, 4.3.4, 4.3.5
4. Calculation of gains & losses	4.4.1, 4.4.2

1. Imposition of tax on gains from realisation of assets and liabilities**1.1 Case for taxing capital gains**

Capital gains, typically, arise upon the sale, exchange or other disposition of a capital asset for more than its purchase price or value on acquisition less costs, if any, of buying or selling and of improving such asset. Such gains constitute, essentially, another form of income and provides the recipient with just as much purchasing power over goods and services as any other form of income, such as interest, dividends, royalties, rents etc. In a tax system based on the principle of ability to pay, it is well accepted that all sources of income which add to a person's purchasing power over goods and services should be included in the income base for determining tax liability.

Capital gains are, generally, taxed not as they accrue but upon realisation. This could lead to "bunching" of gains, given that capital gains realised on disposal of property, very often, represent the appreciation in the value of the property over a number of years. The taxation of such gain in the year of realisation could, at progressive tax rates, result in pushing the recipient to higher tax brackets and may cause hardship or inequity. Such hardship or inequity is, generally, mitigated by the provision of a lower tax rate for taxation of capital gains.

1.2 Historical background to taxation of capital gains in Sri Lanka

Taxation of capital gains was introduced in Sri Lanka in 1959, as a part of the tax reform proposals of Professor Nicholos Kaldor, then commonly referred to as the "Kaldor Reforms". Capital gains taxation, so introduced, covered gains from change of ownership of property as well as from transactions such as surrender or relinquishment of any right in any property and the redemption of any shares, debentures and other obligations (Inland Revenue Act, No. 28 of 1979 lists eight transactions as giving rise to capital gains).

The capital gains arising from a change of ownership of property was subject to tax at differential rates, varying with the period of ownership of the property concerned. The differential rate schedule was intended to distinguish between short term gains and long term gains, with long term gains been considered as reflecting an appreciation in values more due to inflation than short term gains. In other words, where the holding period of a property was longer, inflation may account for, it was held, a larger part of the gain arising on realisation of the property.

The tax treatment of capital gains, whilst retaining its basic features, underwent changes over the years. In 1977, taxation of capital gains arising on death or on gift was abolished and, finally, capital gains taxation terminated, effective from 1st of April 2002.

1.3 Consequences of non-compliance

Refer **Chapter 7**

1.4 Investment Assets

The receipts in respect of the realisation of capital assets or liabilities are liable to income tax under either business income or investment income. Where a capital asset is effectively connected to the business, any gain realised in relation to that asset would form part of business income. Where such capital is held as a passive investment asset, any gain arising would fall under investment income. However, the same set of rules need be applied to ascertain the gain or loss from the realisation.

Where a capital asset is held as part of an investment, such asset is considered as an investment asset. When a person, owning an investment asset, parts with ownership of that asset, when it is sold, exchanged, transferred, destroyed, cancelled, redeemed, lost, expired, expropriated or surrendered, any gain arising there upon would represent a capital gain, subject to tax.

By definition, an investment asset excludes the principal place of residence of an individual, provided it has been owned by the individual continuously for the three years before disposal and lived for at least two of those three years (calculated on a daily basis.)

Refer **Chapter 2** for the definition of a capital asset.

2. Cost of an asset and consideration received

2.1 Cost of an asset and incidental expenditure

Cost of an asset of a person is equal to the sum of expenditure incurred by a person

- in acquiring the asset including, where relevant, expenditure on construction, manufacture or production of the asset;
- in altering, improving, maintaining or repairing the asset; and includes
- **incidental expenditure** incurred by the person in acquiring and realising the asset;

“Incidental expenditure” means -

- advertising expenditure, transfer taxes, duties and other expenditure of transfer;
- expenditure of establishing, preserving or defending ownership of the asset; and
- remuneration for the services of an accountant, agent, auctioneer, broker, consultant, legal advisor, surveyor or valuer relating to the above incidental expenditure.

The cost of an asset shall not include consumption expenditure, excluded expenditure and expenditure to the extent to which it is deducted in calculating person’s income or included in the cost of another asset

Where a person acquires one or more assets by way of transfer at the same time or as part of the same arrangement, the costs can be apportioned according to the market values at the time of acquisition.

If the investment asset is acquired prior to 30th September 2017, market value as at 30th September 2017 is the base date.

- If an income amount is considered as person’s employment income, business income, investment income or other income, then such income should be considered as the cost of the asset when it comes to the calculation of capital gain.

Ex. A block of land has been given to an employee instead of paying his salary in cash. The land value is considered as part of his employment income. When such land is sold, the amount considered as employment income would be cost of the asset.

- If an income amount is exempt or subject to final withholding payment, then such income or final withholding payment should be considered as cost of the asset.

Ex. The prize of winning a lottery is a building. On the value of such building, final

withholding tax payment has been made. When the building is sold, the income considered for deducting WHT has to be considered as the cost of the building.

2.2 Consideration received on realisation of asset.

- Amounts received or receivable by the person for the asset, including the fair market value of any consideration in kind determined at the time of realisation.
- Amounts derived by the person in respect of owning the asset, including
 - amounts derived from altering or decreasing the value of the asset; and
 - amounts derived from the asset including by way of covenant to repair or otherwise; and
- Amounts derived by the person or an entitlement for the person to derive an amount in the future in respect of realising the asset; and includes
- Consideration for grant an option in relation to the asset, if the person is not subject to tax in respect of income or gain made on the grant of the option (promise to purchase).

Consideration received for an asset **should not include** any exempt amount, final withholding tax payment or other than trading stock, an amount directly included in calculating person's income under assessable income. Ex. Sale of a Treasury Bill

3. Realisation of assets and liabilities

3.1 Time of realisation of assets and liabilities

Person who owns the asset is treated as realising the asset-

- when the person who owns the asset **parts with the ownership** of the asset, including when it is sold, exchanged, transferred, distributed, cancelled, redeemed, destroyed, lost, expired, expropriated or surrendered;
- in the case of an asset of a **person who ceases to exist**, including by reason of **the death** of an individual, immediately before the person ceases to exist;

- in the case of an asset other than trading stock or a depreciable asset, where the sum of consideration received from owning the asset exceeds the cost of the asset;
- in the case of a debt claim owned by a person, if he reasonably believes that the debt claim will not be satisfied, where the person has taken reasonable steps in pursuing the debt claim and the person writes the debt off as bad;
- in the case of trading stock, a depreciable asset and a capital asset of a business or an investment asset, immediately before the person begins to employ the asset in such a way that it ceases to be an asset of any of those types;
- **in the case of change of residence** – as per **section 70(2)**, **(when a non-resident becomes a resident of Sri Lanka)**, the net cost of the asset held by the person immediately before becoming resident, should be equal to the market value of the asset; but not related to a domestic asset **-section 70(4)**,
- when a resident ceases to be a resident of Sri Lanka, (other than domestic assets) all the assets should be considered as realised and the market value should be taken into account.

3.2 Realisation with retention of assets

In section 43 of the Act, the calculation of gain or loss on deemed realisation and deemed reacquiring the assets of the person who realises assets in the manner set out in paragraphs (c) to (f) of section 39 are dealt with.

- **Deemed disposal** - refers to a situation where an asset is considered to have been disposed of, even though that investment asset has not been actually transferred.
- **Deemed proceeds of disposal** – refers to a situation where the consideration is deemed to have been received and the value is equal to the market value of the asset at the time of realisation, even though the consideration has actually not been received.
- **Deemed cost** – refers to reacquiring the asset and incurring expenditure of the amount equal to deemed realisation.

3.3 Transfer of assets

3.3.1 Transfer of asset to spouse or former spouse

On transfer of an asset to spouse or former spouse (on death, or as part of a divorce settlement or *bona fide* separation agreement), the gain is calculated on the formula given below (with the written consent):

- **Section 44 (a)**

Individual deriving an amount equal to net cost in respect of realization - Realisation = Net cost of the asset immediately before the realisation.

- **Section 44 (b)**

Person who acquires ownership of an asset equal to net cost - Acquisition cost = Net cost

- Therefore, upon applying above formula, no gain will arise.

3.3.2 Transfer of asset on death

- The Act provides that an individual is treated as realising all of his or her assets and liabilities immediately before his or her death. In principle, the deceased is treated as receiving an amount equal to the net cost at the time of death in respect of the disposal. The result is that the death of an individual is a non-taxing event as regards gains and losses on assets and liabilities.
- Instead, the person who acquires ownership of the asset will be treated as having incurred expenditure of an amount equal to same net cost in acquiring the asset from the deceased, and any gain derived by such person, relative to the net cost, upon subsequent disposal, will be taxed in the hands of such person.

3.3.3 Transfer of asset to an associate or for no consideration

- Where an individual realises an asset by way of transfer of ownership of the asset to an associate of the individual or by way of gift, he is deemed to derive an amount equal to the market value of the asset or net cost of the asset immediately before the realisation.
Where an individual realises an asset by way of transfer to an associate or a charitable institution, he shall be deemed to derive an amount equal to the net cost of the asset immediately before realisation, if the following are met:

- in the case of a transfer to an associate,
 - the associate is the individual's child by marriage or adoption, spouse, parent, grandparent, grandchild, sibling, aunt, uncle, nephew, niece or first cousin; and
 - the asset is an interest in land or a building situated in Sri Lanka, and
- in the case of a transfer to a charitable institution, the transfer occurs by way of gift
- Where a person realises an asset, being a trading stock, a depreciable asset and investment or a capital asset of a business, by a way of transfer of the asset to an associate person, he is deemed to derive an amount equal to the net cost of the asset immediately before the realisation, if the following requirements are met.
 - the person or the associate is an entity;
 - the asset or assets are trading stock, depreciable asset, investment asset or capital asset of a business of the associate immediately after transfer by the person;
 - at the time of the transfer :-
 - the person and the associate are residents; and
 - the associate or, in the case of an associate partnership, none of its partners are exempt from income tax; and
 - there is continuity of underlying ownership in the asset of at least fifty percent.

3.4 Involuntary realisation with replacement

- Section 47 sets out the capital gain tax obligations if an asset is compulsorily acquired.
- There may be a situation where a person receives money or another investment asset (or both) as compensation when a person disposes of an asset involuntarily (or under an insurance policy against the risk of such an event happening). In this case, the person may be able to defer the liability to pay tax on any capital gain arising on the disposal, subject to following conditions:
 - realises the asset (sold, exchanged, transferred, distributed, cancelled, redeemed, destroyed, lost, expired, expropriated or surrendered);
 - acquires a replacement asset of same type, within six months before or after one year of realisation; and
 - elects in writing to state his choice.

3.5 Involuntary realisation by separation

- Section 48 provides another special rule. It deals with the situation where rights or obligations are created with respect to an asset (or liability) owned by the taxpayer.
- The primary issue in a case of this nature is whether the rights created amount to a realisation of part of the asset or whether the granting of the rights creates a new asset (or liability) in the hands of the owner.
- If the rights or obligations are "permanent", then there is a realisation of part of the asset but shall not be treated as acquiring a new asset.
- If the rights or obligations are "temporary or contingent", then there is no realisation of part of the asset but shall be treated as acquiring a new asset.
- Under s. 48(2), rights or obligations created shall be considered permanent if they exceed 50 years.
Therefore, if a person, who owns land, grants a lease for more than 50 years, such lease will be treated as a realisation of the land. If the person grants a lease for less than 50 years, such lease will not be a part realization.

4. Calculation of gains and losses

4.1 Calculation the gain or loss from realisation of assets and liabilities

Capital gain is calculated as the difference between the consideration received and the cost of the investment asset at the time of realisation.

A gain will be computed as follows:

Consideration received	= xxx
<u>Less:</u>	
Cost of the asset or Liability	= (xx)
Gain or loss	= xxx

4.2 Payment of tax on realisation of gains

4.2.1 Tax Rate and Exemptions

- Capital gains are taxed at the rate of 10%.
- Personal allowance of Rs.500, 000 is not allowed to be claimed against the gain on realisation of assets.
- For a resident individual, capital gains not exceeding Rs.50,000 on realisation of an investment asset and capital gains not exceeding Rs.600,000 during the year of assessment are exempt.
- Capital gains on sale of shares held as an investment is exempt.
- Gain on realisation of shares in a non-resident company with respect to substantial participation in the non-resident company is also exempt (Refer item (r) of the Third Schedule).
- Gain derived by an individual on disposal of his principal place of residence, provided it was owned by him continuously for 3 years and lived in for at least 2 years is exempted.

4.2.2 Submission of capital gain returns

- Return is to be filed not later than one month after the date of realisation of the investment asset (section 93(3)).
- A separate return must be filed in respect of each transaction.
- Individuals must account for gains on cash basis, unless otherwise approved by the Commissioner General of Inland Revenue.
- A tax credit is available on any tax paid by instalment for the year attributable to the gain (section 93(4)(iii))

CHAPTER ROUNDUP

- Cost of an asset and Consideration received on realisation of asset should be calculated as explained in the Inland Revenue Act.
- Capital gain is calculated as the difference between the consideration received and the cost of the investment asset at the time of realisation.
- Capital gains are taxed at the rate of 10%.
- There are exemptions for capital gain tax.

PROGRESS TEST

- 1 Provide formula to calculate capital gain tax.
- 2 Mr. Perera bought a house in Colombo during November 2015. He renovated and live in that house from January 2017. However, he sold the house in November 2019. Advise, whether Mr. Perera is liable to pay capital gain tax.
- 3 Out of the following investments, which one is not exempt from capital gain tax?
 - A. Sale of shares held as an investment
 - B. Sale of debentures held as an investment
 - C. capital gains not exceeding Rs.50,000 on realisation of an investment asset for a resident individual
- 4 **When** the capital gain tax return is due to file with the Department of Inland Revenue?

- 1 A gain will be computed as follows:

Consideration received	= xxx
<u>Less:</u>	
Cost of the asset or Liability	= <u>(xx)</u>
Gain or loss	= <u>xxx</u>

- 2 There is an exemption for a gain derived by an individual on disposal of his principal place of residence, provided it was owned by him continuously for 3 years and lived in for at least 2 years

Mr. Perera has bought the house 4 years ago and lived in that house more than 2 years. Therefore, any gain on disposal of the house is exempt from capital gain tax.

- 3 Sale of debentures held as an investment
- 4 Return is to be filed not later than one month after the date of realisation of the investment asset

Value Added Tax (VAT)

Knowledge Component

E. Value Added Tax (VAT)

5.1 Obligation of a VAT registered person	5.1.1	Imposition of value added tax along with the definitions for the terms “taxable activity”, “taxable supply”, “supply of goods”, “supply of services”, “time of supply”, “taxable period” and “registered person”.
	5.1.2	Advise the statutory obligations with regard to furnishing returns, payment of tax and documentation.
	5.1.3	Assess output tax, input tax and balance tax payable by a registered person in business, which carries out multiple activities.
5.2 Simplified VAT Scheme	5.2.1	Assess the VAT liability of a registered identified purchaser and registered identified supplier.
	5.2.2	Outline the significant features of the Simplified VAT Scheme.
5.3 Managing VAT in a business	5.3.1	Explain statutory provisions of the VAT Act with regard to assessments, time-bar for assessments, appeals and appeal settlement procedure.
	5.3.2	Analyze VAT issues in a complex business environment and provide appropriate actions to mitigate such situations.

CHAPTER CONTENTS

1. Obligation of a VAT registered person
2. Simplified VAT Scheme
3. Managing VAT in a business

LEARNING OUTCOME

- 5.1.1, 5.1.2, 5.1.3
5.2.1, 5.2.2
5.3.1, 5.3.2

1. Obligation of a VAT registered person**1.1 Imposition of Value Added Tax (VAT)**

VAT is an indirect tax imposed on consumption of goods and services, in which tax is charged at each stage of passing the goods and services to the final customers. However, it is collected via VAT-registered persons as a tax collector on behalf of the Department of Inland Revenue as per the Value Added Tax Act, No. 14 of 2002.

1.2 Chargeability of VAT

- a) Every registered person is liable for VAT at the time of supply on every taxable supply of goods or services, in the course of carrying on or carrying out taxable activity in Sri Lanka; and
- b) Any person who imports goods into Sri Lanka is liable for VAT.

1.3 Taxable Activity

Taxable activity includes any activity carried on as a business, trade, profession or vocation

According to the VAT Act “**taxable activity**” means –

- (a) any activity carried on as a business, trade, profession or vocation other than in the course of employment or every adventure or concern in the nature of a trade;
- (b) the provision of facilities to its members or others for a consideration and the payment of subscription in the case of a club, association or organization;
- (c) anything done in connection with the commencement or cessation of any activity or provision of facilities referred to in (a) or (b);
- (d) the hiring, or leasing of any movable property or the renting or leasing of immovable property or the administration of any property;

(e) the exploitation of any intangible property such as patents, copyrights or other similar assets where such asset is registered in Sri Lanka or the owner of such asset is domiciled in Sri Lanka;

1.4 Taxable Supply

Taxable supply means any supply of goods or services made in Sri Lanka which is chargeable to tax and includes a supply charged at the rate of zero percent other than exempt supplies.

1.5 Supply of Goods

The passing of exclusive ownership of goods to another as the owner of the goods or under the authority of any written law. This includes sale of goods by public auction, transfer of goods under a hire purchase agreement, the sale of goods in satisfaction of a debt and the transfer of goods from a taxable activity to a nontaxable activity.

1.6 Supply of Services

Supply of services means any supply, which is not a supply of goods. This includes any loss incurred in a taxable activity for which an indemnity is due. For an example, insurance claim received from an insurance company under an insurance policy is a supply of service.

1.7 Time of Supply

A registered person has to identify at which point he has to charge VAT from the supply of goods or services. The time of supply rules are summarized below.

- (i) Time of **supply of goods** is the earliest of:
 - a. Date of invoice
 - b. Date of receipt of payment/advance
 - c. Due date of payment
 - d. Date of delivery (if the invoice is issued within 10 days of delivery date, then the time of supply shall be the date of invoice)

- (ii) Time of **supply of services** is the earliest of:
- a. Date of invoice
 - b. Date of receipt of payment/advance
 - c. Due date of payment
 - d. Date of performance of services (if the invoice is issued within 10 days of performance of services, then the time of supply shall be the date of invoice)
- (iii) Where the Commissioner General has granted permission to apply cash basis, the time of supply is the date on which payment is received.
- (iv) In case of hire purchase agreement on the supply of goods, the time of supply is the time at which the agreement is entered into.
- (v) Time of supply in respect of any agreement other than hire purchase which provide for periodical payment is when the payment is due or when the payment is received, whichever occurs earlier.

1.8 Taxable Period

Taxable period means,

- (a) A period of one month for the following person:
- Where any person registered with SVAT scheme and accorded Registered Identified Purchaser (RIP) status
 - Where any person under the project implementation period and registered as per the Section 22(7) of the VAT Act.
- (b) A period of three month for the following person:
- Person other than in (a) above.

1.9 Registered Person

A person who pay VAT to the Government is known as registered person. The VAT registration is subject to the threshold.

VAT thresholds are given below:

1.9.1 Taxable suppliers of goods and services

Any person who made supply of taxable goods or services in excess of Rs.12 Million per year or Rs.3 million per quarter (taxable period) from 01 April 2016 is required to register for VAT.

** There are certain goods and services exempted from VAT. Such exempted supply should be excluded in calculating above annual and quarterly turnover thresholds.

1.9.2 Importers

All importers are required to register for VAT (permanently or temporary) irrespective of the VAT threshold.

1.9.3. Retail and wholesale activities

Liable turnover limit is Rs.100 million for any 3 months period in any calendar year from 01st January 2015 to 31st October 2016. The liable turnover limit is reduced with effect from 01st November 2016 to Rs.12.5 million applicable for any 3 months period in any calendar year.

Trading transactions (i.e. retail and wholesale of any article by a person other than the manufacturers or the importers) below the above limit are excluded from the scope of VAT.

1.10 Consequences of registration

Once registered, a person must charge and collect VAT even if the value of supplies does not exceed the registration threshold.

Deregistration cannot be done within the first 12 month-period of registration. After completion of the 12 months, request for cancellation can be made subject to the liability on deemed disposal of remaining stock, assets, etc.

1.11 VAT Rates

VAT is charged under two rates named standard rate and zero rate.

- (a) The standard rate applicable from 01st November 2016 is 15%.

(b) The following are the key zero rated supplies:

- Export of goods
- Services which are directly connected with:
 - i. any movable or immovable property outside Sri Lanka
 - ii. any repair of foreign ship, aircraft or any merchant ship registered in Sri Lanka or refurbishment of marine cargo containers
 - iii. any goods imported for the purpose of re-export
 - iv. copyright, patent, license, trademark or similar intellectual property right to the extent that such right is for use outside Sri Lanka
 - v. international transportation (goods and passengers) for example; sea freight, air tickets
 - vi. software developed by the developer for use wholly outside Sri Lanka
 - vii. client support services outside Sri Lanka for payment in foreign currency
 - viii. provision of services to the overseas buyers by a garment buying office
- Any other services provided by any person in Sri Lanka to another person outside Sri Lanka to be consumed or utilized outside Sri Lanka for payment in foreign currency in full received from outside Sri Lanka through a bank in Sri Lanka.

1.12 Exempt and zero rated supplies

Exempt supplies

A list of exempted supplies is given in the Part II of the First Schedule of the Act. A few exempted supplies extracted from the Schedule are as follows.

(a) The supply or import of:

- Rice flour
- Wheat, wheat flour, bread
- Tea, including green leaf
- Pharmaceuticals
- Books (other than newspapers, magazines, exercise books etc)
- Computers

(b) The supply of:

- Educational services
- Public passenger transport services
- Electricity
- Locally developed software

The difference between zero-rated and exempted supplies

When a supply is zero rated, it means that the supply is liable to tax, but the rate applied is zero. If a supply is exempted, the supply is not liable to VAT.

The main difference between zero rated and exempted supply is that in the case of zero rated supplies, the person is entitled to claim input taxes paid by him on goods purchased or imported and services used by him, though the output tax is nil. On the other hand, in the case of exempted supplies, while the person cannot charge VAT on his supplies, he cannot claim the input taxes.

1.13 Output Tax

Output tax is the tax payable on the value of supplies (sales) at the relevant rate.

1.14 Input Tax

Input tax is the VAT paid by a registered person on the purchases of goods and services and on imports.

The following input taxes are not allowed as credits:

- Purchases and expenses relevant to non-taxable activities.
- Input tax not claimed within 12 months from the date of any tax invoice (in relation to local purchases) or within 24 months from the date of any Customs Declaration (in relation to imports).
- Input tax on motor cars and double cabs used for own travelling purposes.
- In a situation where input taxes are not supported with a valid tax invoice.

Deemed input tax

Any person who has obtained the VAT registration after 02nd May of 2016 in respect of wholesale or retail business, is entitled to claim a deemed input credit on purchases from non-registered persons other than on a tax invoice. The credit for input tax on tax invoice or deemed input tax is allowed subject to certain restrictions.

Restriction on total input tax

Effective from 01 January 2011 the deduction of input tax is restricted to the amount of output tax declared for that period. Any balance can be carried forward and claimed in the subsequent period. However, this restriction is not applicable to input tax related to zero rated supplies as well as on suspended supplies.

1.15 Tax Invoice

Since the liability of VAT is chargeable from the customer, the supplier (seller) is required to issue tax invoice when supplying to another VAT registered person.

The VAT is calculated on an input tax / output tax basis. Therefore, for the administration of VAT, the Tax Invoice is very important.

The tax invoice should be issued by a VAT-registered person to another VAT- registered person only.

The tax invoice should contain the following particulars:

- the name, address and the VAT registration number of the supplier
- the name, address and the registration number of the person to whom the supply is made
- the date on which the tax invoice was issued and its serial number
- the date of supply and the description of goods or services
- the quantity or the volume of supply
- the value of supply, VAT charged and the consideration for the supply
- the words “TAX INVOICE” in a conspicuous place

1.16 Computation of VAT Liability

VAT is collected only on the value addition by each supplier. Accordingly, VAT paid on raw materials purchased and other service purchases are allowed as input credits against output tax (VAT on supply). The basic formula for computation of VAT is as follows.

$$\text{VAT payable} = \text{Output VAT} - \text{Input VAT}$$



1.16.1 Example: Balance VAT payable

“Samarasinghe Brothers” is a manufacturer of food products. Calculate the balance VAT payable for the quarter ended **31 December 2018**, with the following information:

- Value of supply (total sales) including VAT: Rs.3,552,000
- Excess input credit for the quarter ended 30th September 2018: Rs.28,000
- Raw materials purchased from registered persons: Rs.1,000,000 + VAT
- Raw materials from non-registered person: Rs.600,000
- Transport service obtained from VAT registered person Rs.33,300 with VAT
- Transport service obtained from non-registered person Rs.25,000

The VAT computation for the period will be as follows.

Output tax	3,552,000 x 15/115	463,304
Input tax		
On purchases from registered person 1,000,000 x 15%	150,000	
On purchases from non-registered persons	Nil	
Paid to registered transporters 33,300 x 15/115	4,343	
Paid to non-registered transporters	Nil	
Allowable input during the period	154,343	
Add: Brought forward from previous period On purchases from registered persons	28,000	(182,343)
Balance tax payable		280,961



1.16.2 Example: Balance VAT payable (excluding VAT)

“Wickramage Brothers” manufactures footwear for the local market. The following information has been provided for the three-month period (quarter) ended on 31st December 2018.

- Value of supplies (excluding VAT): Rs.3,000,000
- Input tax paid during the quarter:
 - On raw material purchased from local supplies: Rs.220, 000
 - Paid to Custom on imported raw material: Rs.180, 000
 - On machinery purchased: Rs.72, 000
 - On advertising bills: Rs.24, 000

The VAT computation for the period will be as follows.

Output tax	3,000,000 x 15%	450,000
Input tax		
Purchased from local supplies	220,000	
Paid to Custom on imports	180,000	
On machinery purchased	72,000	
On advertising	24,000	
<i>Total input tax</i>	496,000	
Limit of credit = 100% of output tax	(450,000)	(450,000)
Balance input tax carried forward	46,000	
Balance tax payable		Nil

1.17 VAT Payment

Manufacturers

VAT payment is made on monthly basis on or before 20th of the following month.

Example: The VAT payment for the month of January 2019 should be paid on or before 20 February 2019.

Others

VAT payment for the period from 01st to 15th of the month should be paid on or before last date of the same month. The payment for the period from 16th to 31st on or before the 15th of the following month.

Example: The VAT payment for the month of January 2019 should be paid as follows:

From 1 January 2019 to 15 January 2019 - payment should be made on or before 31 January 2019.

From 16 January 2019 to 31 January 2019 – payment should be made on or before 15 February 2019.

1.18 Filing of VAT Returns

VAT return with relevant schedules for each taxable period is to be submitted on or before the last day of the subsequent month.

2. Simplified VAT System

The Department of Inland Revenue has introduced SVAT scheme with effect from 01st April 2011 to minimize the VAT refunds.

The registered person who is qualified under this scheme, do not pay input tax in cash. The VAT is suspended and instead of cash, a credit voucher will be issued.

Registered Identified Purchaser (“RIP”)

A person registered under SVAT scheme as a purchaser is called RIP and his input tax is suspended under the SVAT scheme.

Following are the key persons eligible to register as a RIP.

- Zero rated supplier – if more than 50% of its total supplies are zero rated.
- Supplier who has made supplies to RIP under the Simplified VAT Scheme - if it is more than 50% of its total supplies.

- Persons who are registered under section 22(7) during the project implementation period.
- Persons making supplies to a Strategic Development Project.

Registered Identified supplier (“RIS”)

A person registered under SVAT scheme as a supplier is called RIS and his output tax is suspended under the SVAT scheme.

There is no VAT charged on the invoices issued on supplies made by RIS to the said RIP. The invoice issued by RIS to RIP on suspended supply is recognized as ‘Suspended Tax Invoice’.

The RIP is required to obtain credit voucher from the Department of Inland Revenue and to issue such credit vouchers to the respective suppliers (RIS) to prove the suspended VAT amount.

Further, both RIP and RIS are required to file with the Department of Inland Revenue the relevant documents specified under the SVAT scheme.



- 1) Quality Associates is a firm providing professional services. It is registered for VAT and also a Registered Identified supplier (“RIS”). The following information has been provided for the three-month period (quarter) ended on 30th September 2019.
 - Value of supplies to VAT registered local clients (excluding VAT): Rs.2,000,000.
 - Value of supplies to foreign clients in abroad: Rs.750,000.
 - Value of supplies to local clients registered for SVAT (excluding VAT): Rs.1,000,000.
 - Input tax paid during the quarter: Rs.250,000.

The VAT computation for the period will be as follows.

		Suspended VAT	VAT
Output tax			
Local clients	2,000,000 x 15%	-	300,000
Foreign clients	750,000 x 0%	-	-
Local clients - SVAT	1,000,000 x 15%	150,000	150,000
<i>Total output tax</i>			450,000
Input tax			
Limit of credit = 100% of output tax	250,000		(250,000)
Tax payable	-		200,000
Tax Credits-SVAT credit vouchers collected from clients			(150,000)
Balance tax payable			50,000



2) Lanka Gloves (Pvt) Limited is a manufacture of surgical gloves to export market. The Company is registered as a Registered Identified Purchaser ("RIP"). The following information has been provided for the three-months period (quarter) ended on 30th September 2019.

- Value of exports: Rs.18,000,000
- Value of scrap sales (excluding VAT): Rs.100,000
- Input tax paid during the quarter: Rs.25,000
- SVAT Purchases during the quarter (value of suspended tax): Rs.850,000

The VAT computation for the period will be as follows.

		Suspended VAT	VAT
Output tax			
Exports sales	18,000,000 x 0%	-	-
Scrap sales	100,000 x 15%	-	15,000
Total output tax			15,000
Input tax			
Limit of credit = 100% of output tax	25,000		(15,000)
Balance input tax carried forward	10,000		
SVAT purchases – credit vouchers issued to suppliers		850,000	
Balance tax payable			Nil

3. Managing VAT in a business

The Assistant Commissioner of the Department of Inland Revenue is empowered to assess the VAT return filed by tax payers and issue **notice of assessment**.

3.1 Time bar period

The assessment should be made by the assistant commissioner within the time limit given in the VAT Act. This period is called **time bar** period.

3.1.1 Three years

If a registered person (taxpayer) filed a VAT return on or before the due date, the assistant commissioner can make an assessment or additional assessment within 3 years from the end of the taxable period.

Example: VAT return for the quarter ended 31st December 2016. This was due to file on or before 31st January 2017.

If a taxpayer filed the VAT return on or before the 31st January 2017, the Assistant Commissioner can issue an assessment for such VAT return on or before 31st December 2019.

3.1.2 No time bar

In the following instances, the time bar provision of three years will not apply.

- VAT return has not been filed by the tax payer
- VAT return filed after the due date specified in the VAT Act
- If the assistant commissioner is of the view that willful or fraudulent activities are involved

3.2 Assessment

The assessment can be issued under the following circumstances.

- Any registered person fails to furnish a return for any taxable period.
- Any registered person filed a return in respect of any taxable period but fails to pay the tax for that taxable period.
- Any person requests to make any alteration or addition to any return furnished by such person for any taxable period.
- Where, in the opinion of the Assistant Commissioner, the amount paid for any taxable period is less than the actual amount payable by such person for that taxable period.

3.3 Appeals

Any registered person can appeal to the Commissioner General of the Inland Revenue, if he is dissatisfied with any assessment or additional assessment made on him by an Assistant Commissioner, or a penalty imposed under the VAT Act.

The registered person who makes an appeal is called an **appellant**. The appeal should be made within thirty days after the service of notice of assessment.

The Commissioner General shall grant an extension of time for preferring the appeal upon being satisfied that owing to absence from Sri Lanka, sickness or other reasonable cause, the appellant was prevented from appealing within such period.

3.3.1 Conditions for a Valid Appeal

The registered person should make a valid appeal. For this purpose, the appeal must conform to the under mentioned conditions.

- The appeal must be preferred by a petition in writing or by electronic means addressed to the Commissioner General within 30 days after the service of notice of assessment.
- The letter of appeal should state precisely the grounds of appeal.
- Where the appeal is against an estimated assessment made in the absence of a return, the appeal should be accompanied by a return with proof of payment of tax and penalty.
- Taxes must have been paid as per the return with penalty. (However, the Commissioner General may grant an extension of time for the payment of such taxes and penalty considering the serious financial hardship suffered by the appellant or other reasonable cause.)

Every petition of appeal which was not made within the period specified under the Act or does not conform to the above conditions shall not be valid.

3.4 Appeal settlement procedure

Once an appeal is made against an assessment, the settlement process may involve all or part of the following procedures. It is important to understand that the procedures follow one after the other according to an order.

3.4.1 Appeal before the Assistant Commissioner

On receipt of a valid petition of appeal, the Commissioner General may cause further inquiry to be made by an Assistant Commissioner other than the Assistant Commissioner who made the assessment.

During this inquiry, if there is any agreement reached as to the matters specified in the petition of appeal, the necessary adjustment to the assessment shall be made.

3.4.2. Appeal before the Commissioner General

If no agreement is reached between the appellant and the Assistant Commissioner as discussed above, the Commissioner General shall fix a time and place for the hearing of the appeal.

The VAT Act specifies the powers given to the Commissioner General for this purpose. In determining an appeal, the Commissioner General may confirm, reduce, increase or annul the assessment and shall give notice in writing to the appellant of his determination on the appeal.

Every petition of appeal shall be agreed or determined by the Commissioner General within two years from the date on which such petition of appeal is received by the Commissioner General.

3.4.3 Appeals to the Tax Appeals Commission

Any person aggrieved by the determination of the Commissioner General may appeal from such determination to the Tax Appeals Commission and the provisions of the Tax Appeals Commission Act, No. 23 of 2011 relating to appeals shall apply accordingly. Any appeal made to the Tax Appeals Commission shall be determined within a period of 270 days from the date of commencement of the hearing of such appeal.

3.4.4 Appeal on a Question of Law to the Court of Appeal

The decision of the Tax Appeal Commission is final in terms of VAT Act.

However, the tax payer can make an application to the Court of Appeal for a writ of certiorari for quashing the determination of the Tax Appeals Commission.

3.4.5 Finality of an assessment

The assessment as made or reduced or increased or confirmed on appeal, shall be final and conclusive under the following circumstances.

- Where no valid appeal has been preferred within the time specified in the VAT Act against an assessment, or
- Where the amount of tax has been determined on appeal.

- $\text{VAT payable} = \text{Output VAT} - \text{Input VAT}$
- Certain input taxes cannot be claimed.
- Zero-rated suppliers can claim all input tax though no output tax is payable.
- Under simplified VAT system do not pay input tax in cash instead credit voucher is issued

PROGRESS TEST

- 1 **List** a few exempt supplies.
- 2 **List** a few zero-rated supplies.
- 3 **State** the VAT registration threshold applicable for the quarter from 01st September 2019 to 31st December 2019.
- 4 Which one of the following is NOT a requirement for a “tax invoice”?
 - A. Name and address of the supplier
 - B. VAT registration number of the supplier
 - C. Date
 - D. Income tax registration number of the supplier
- 5 **Identify** the input tax that could be claimed:
 - A. Input tax on expenses not relevant to the business
 - B. Input tax not supported with a valid tax invoice
 - C. Input tax on raw material purchased
 - D. Input tax not claimed within 12 months from the date of tax invoice
- 6 Time of supply of goods for VAT purposes is the point where VAT liability should be recognized. It does NOT occur due to:
 - A. Reservation of goods for a customer
 - B. Issue of invoice
 - C. Receipt of payment
 - D. Delivery of goods

ANSWERS TO PROGRESS TEST

- 1 Rice, rice flour, wheat flour, pharmaceutical, computers
- 2 Export of goods, Service rendered outside Sri Lanka, International transportation
- 3 Rs. 3 million per quarter or Rs. 12 million per
- 4 year. D Income tax registration number of the
- 5 supplier C Input tax on raw material purchases
- 6 A Reservation of goods for a customer

Other Taxes applicable to businesses

Knowledge Component

F .Other Taxes applicable to businesses

6.1 Nation Building Tax (NBT)	6.1.1 Explain the applicability of NBT to small- and medium-sized businesses, and the registration threshold. 6.1.2 List a few excepted articles and services. 6.1.3 Compute tax payable in a straightforward, non- complex scenario. 6.1.4 Explain the due dates of payment and submission of returns.
6.2 Economic Service Charge (ESC)	6.2.1 Explain the applicability of ESC to small-and medium-sized businesses, and the registration threshold. 6.2.2 Compute tax payable in a straightforward, non-complex scenario. 6.2.3 Explain the due dates of payment
6.3 Stamp Duty	6.3.1 Explain stamp duty payable to Provincial Councils on immovable properties and calculate stamp duty on sale & gift of properties. 6.3.2 Explain stamp duty payable to Central Government on specified instruments and calculate stamp duty based on given rates.

Nation Building Tax (NBT)

CHAPTER CONTENTS

1. Applicability of NBT
2. Excepted articles and services
3. Computation of NBT Liability
4. NBT Compliance

LEARNING OUTCOME

- 6.1.1
- 6.1.2
- 6.1.3
- 6.1.4

1. Applicability of NBT

1.1 Imposition and scope of NBT

Importers and person engaged in business of manufacture, provision of service and wholesale and retail sales are required to pay Nation Building Tax (NBT) on liable turnover as per the Nation Building Tax Act, No. 9 of 2009.

1.2 Who is liable for NBT

NBT is payable by every person (individual, company or body of persons) or partnership who:

- i. Imports any article into Sri Lanka,
- ii. Carries on the business of manufacture of any article, (excluding excepted articles),
- iii. Carries on the business of providing a service of any description (excluding excepted services), or
- iv. Wholesale and retail business (excluding excepted article).

1.3 Threshold for NBT

The following turnover thresholds are applicable for NBT registration.

- a) Liable Turnover from the supply of any goods or services (other than goods or services referred to in paragraph (b) below) which exceeds Rs.3,750,000 in any quarter from 1 January 2015 up to 31st March 2016. This threshold is reduced as Rs.3,000,000 and if it exceeds Rs.3,000,000 in any quarter from 01st April 2016 onwards.

- b) Liable turnover from a processing of any locally produced agricultural produce in the preparation for sale which does not exceed Rs.25,000,000 in any quarter is not liable for NBT for that quarter.

1.4 Liable Turnover

For imports of any article: Value for NBT on import of any article is calculated on the same basis as ascertained for the purpose of VAT.

For manufacture of any article/ providing any Services: Any sum receivable whether received or not from the sale of goods or services other than excepted article or services.

For wholesale or retail sale of any article: Any sum receivable whether received or not from the sale in that quarter other than following:

- Pharmaceuticals
- Sugar, dhal, potatoes, onions, dried fish, milk powder or chilies under the provisions of the Special Commodity Levy Act, No. 48 of 2007, where such article is subsequently sold by the importer of such article
- Gem or Jewelry sold on the payment in foreign currency
- Any printed books
- Any article sold to any exporter for export
- Fresh milk, green leaf, cinnamon or rubber purchased from any manufacturer or producer
- Petrol, diesel or kerosene sold in a filling station.
- Retail sale of any article at duty free shops payment in foreign currency
- Distribution of LP gas
- Any motor vehicle identified under Harmonized Commodity Description and Coding Numbers for Custom purpose and liable to Excise Duty under the Excise (Special Provision) Act, such vehicles are sold by the importer himself;
- Cigarettes identified under Harmonized Commodity Description and Coding Numbers for Custom purpose and liable to Excise Duty under the Excise (Special Provision) Act, such cigarettes are sold by the importer himself;
- Liquor identified under Harmonized Commodity Description and Coding Numbers for Custom purpose and liable to Excise Duty under the Excise (Special Provision) Act, such liquors are sold by the importer himself prior to April 01, 2018

Also, note that when calculating the liable turnover of the above categories other than import of any article, following need to be deducted from the liable turnover;

- Any bad debts incurred
- Any VAT paid
- Any excise duty paid

However, when the bad debts are recovered it need to be included in the turnover.

1.5 Rates of NBT

a) On the liable turnover of manufacturer of any article	2%
b) On the liable turnover of any service provider	2%
c) In the case of a distributor , ¾ of the liable turnover On the balance liable turnover	Nil 2%
d) Wholesale or retail sale of any article other than of a distributor , ½ of the liable turnover On the balance liable turnover	Nil 2%

1.6 Applicability of input tax credit

Manufacturers are entitled to claim tax credits in respect of NBT paid on goods purchased from a manufacturer or goods imported by himself.

2. Excepted articles and services

A list of excepted articles and services is provided in the Schedule to the Act. A few examples are listed below:

- Any article exported by the manufacturer
- Fertilizer
- L. P. Gas
- Pharmaceuticals
- Coal
- Medical services
- Supply of electricity and water
- Transport of goods or passengers
- Exhibiting films in a cinema
- Supply of locally developed software
- any service rendered in or outside Sri Lanka to any person or partnership outside Sri Lanka for the utilization out of Sri Lanka for payment in foreign currency if such foreign currency is remitted to Sri Lanka through a bank

3. Computation of NBT liability

3.1 Example: Computing NBT

Mr. Perera has a business of supplying building materials to building constructors and retail customers. He sells cement blocks manufactured both by him and various suppliers. In addition, he is the distributor for the manufacturer of a well-known brand of paints in the Colombo district.

His turnover figures for the quarter ended 31 December 2018 are as follows.

Sale of cement blocks manufactured by him (excluding VAT): Rs.3,200,000
Sale of other articles: Rs.6,000,000

Distribution of paints: Rs.4,000,000

A sum of Rs.200,000 (excluding VAT) receivable from a buyer of cement blocks has become irrecoverable.

Paid NBT amounts to Rs.65,000 to another manufacturer to purchase items for cement block manufacturing.

The NBT payable for the quarter is as follows:

Activity	Liabile turnover	Rate	NBT payable
Manufacture and sale of cement blocks	$(3,200,000 - 200,000)$ $= 3,000,000$	2%	60,000
Turnover from wholesale and retail business	$6,000,000 \times \frac{1}{2}$ $= 3,000,000$	2%	60,000
Turnover from distributorship	$4,000,000 \times \frac{1}{4}$ $= 1,000,000$	2%	20,000
Total			140,000
Tax credit for manufacture	(balance Rs.5,000 to be carried out for next period)		(60,000)
Total NBT payable			80,000

4. NBT Compliance

4.1 Payment, return and administrative provisions

The period for NBT is the relevant quarter. Quarter means the period of three months commencing from January 01, April 01, July 01 and October 01 of each year.

NBT is payable on a self-assessment basis in three monthly instalments for each quarter. Each instalment should be an amount not less than one third (1/3) of NBT payable for the quarter.

- (i) the NBT payable for the first month of that quarter on or before the 20th day of the second month of that quarter
- (ii) the NBT payable for the second month of that quarter on or before the 20th day of the third month of that quarter;
- (iii) the balance NBT payable for that quarter on or before the 20th day of the month immediately succeeding the end of the relevant quarter, calculated by deducting the NBT paid under (i) and (ii) above.

Return of NBT should be furnished on or before the 20th day of the month immediately succeeding the end of that relevant quarter. (i.e. the NBT Return for the quarter ended 30 June 2019 should be filed on or before the 20th of July 2019) .

Provisions relating to returns, assessments, penalties and other administrative provisions are applicable as provided in the Inland Revenue Act, No. 10 of 2006.

CHAPTER ROUND UP

- ↳ NBT should be paid by importers, manufacturers, service providers and wholesale and retail businesses.
- ↳ There are certain excepted articles and services.
The turnover limit for registration of general businesses is Rs.3 million per any quarter from 01 April 2016.

PROGRESS TEST

- 1 **State** the turnover threshold for charging NBT for a general business for the period from 1 April 2016.
- 2 **State** how you calculate the NBT liability for a distributor.
- 3 **State** the deadline for submission of NBT returns.

ANSWERS TO PROGRESS TEST

- 1** Rs. 3 million per quarter from 01st April 2016.
- 2** 3/4th (75%) of the turnover of a distributor is considered as nil and the balance 1/4th of the liable turnover is taxable at 2%
- 3** 20th of the following month (after end of each quarter)

Economic Service Charge (ESC)

CHAPTER CONTENTS

5. Applicability of ESC
6. Computation of ESC Liability
7. ESC Compliance

LEARNING OUTCOME

- 6.2.1
- 6.2.2
- 6.2.2, 6.2.3

5.Applicability of ESC

5.1 Imposition and scope of ESC

Every person and every partnership are liable to pay ESC on relevant turnover of such person or partnership for every quarter of every year of assessment.

5.2 Who is liable for ESC

ESC is payable by a “person” or a “partnership”. For this purpose, “Person” includes a company or body of persons, but does not include the following:

- (a) any registered society within the meaning of the Co-operative Societies Law No. 5 of 1972 or under the respective Statue enacted by a Provincial Council providing for such registration;
- (b) any person carrying on business as an owner or charterer of an aircraft or ship;
- (c) any Government Institution or any local authority as defined in the Inland Revenue Act, No. 10 of 2006;

(d) any distributor;

For this purpose, distributor in relation to any manufacturer or producer of any goods in Sri Lanka means any person or partnership appointed by such manufacturer or producer for the sale in the wholesale market of such goods at such price as may be determined by such manufacturer or producer from time to time.

(e) any dealer in a lottery;

(f) any Unit Trust or Mutual Fund;

(g) The Central Bank of Sri Lanka prior to March 31, 2017; and

(h) Lak Sathosa Limited (with effect from April 01, 2011)

5.3 What is the relevant turnover

Relevant turnover of every trade, business, profession or vocation carried on or exercised by any person or partnership is the aggregate turnover of the relevant quarter.

The Turnover means total amount receivable, whether actually received or not from every transaction entered into in that relevant quarter from such trade, business, profession or vocation.

Also note that when calculating relevant turnover, there are some items need to be deducted from the relevant turnover. The following are the key deductions from turnover to arrive the relevant turnover.

- Any VAT paid
- Any bad debts incurred

5.4 Threshold for ESC

Any person or partnership is liable to ESC only if the relevant turnover exceeds Rs.12,500,000 per quarter for any quarter commencing from 01st April 2017.

5.5 ESC rate

The ESC rate applicable for the any quarter commencing on 01stApril 2016 is as follows:

The relevant turnover other than the relevant turnover of the retail sale of petrol, diesel or kerosene	0.5%
The relevant turnover from the retail sale of petrol, diesel or kerosene	
1/10 of the relevant turnover	0.5%
9/10 of the relevant turnover	Nil

5.6 Setoff of ESC against Income Tax

ESC paid by any person, can be set off against the income tax payable by such person during the same year of assessment or within next two years of assessment.

For an example: ESC paid for the year of assessment 2017/2018 can be set off against the income tax liability of the

- 1) Year of assessment 2017/2018
- 2) If any balance against Year of assessment 2018/2019
- 3) If any balance against Year of assessment 2019/2020

6.Computation of ESC

6.1 Example: Computing ESC liability

Mr. Perera has a business of supplying building materials to building constructors and retail customers. He sells cement blocks manufactured both by him and various suppliers. In addition, he is the distributor for the manufacturer of a well-known brand of paints in the Colombo district.

His turnover figures for the quarter ended 31 December 2018 are as follows.

Sale of cement blocks manufactured by him (excluding VAT): Rs.3,200,000
Sale of other articles: Rs.6,000,000.

Distribution of paints: Rs.4,000,000.

A sum of Rs.200,000 (excluding VAT) receivable from a buyer of cement blocks has become irrecoverable.

The ESC payable for the quarter is as follows:

Activity	Relevant Turnover	Rate	ESC Payable
Manufacture of cement blocks	$3,200,000 - 200,000 = 3,000,000$	0.5%	15,000
Sale of other articles	6,000,000	0.5%	30,000
Distribution of paints	4,000,000	0.5%	20,000
Total ESC payable			65,000

7.ESC Compliance

7.1 ESC payments

ESC is payable as a quarterly payment on or before the 20th day of the month immediately succeeding the end of that relevant quarter.

For an example: ESC liability for the quarter ended on 30th September 2019 should be paid on or before 20th October 2019.

7.2 ESC Return

ESC return is required to be filed annually on or before the 20th day of April of each year.

For an example, ESC returns for the year ended 31st March 2020 (which is called the year of assessment 2019/2010) to be filed on or before 20th April 2020.

Stamp Duty

CHAPTER CONTENTS

8. Stamp Duty payable to Central Government
9. Stamp Duty payable to Provincial Council

LEARNING OUTCOME

- 6.3.1
- 6.3.2

8. Stamp Duty payable to Central Government

Stamp Duty was another scheme of taxation generally imposed on the execution of instruments.

8.1 Imposition of Stamp Duty by Central Government

Stamp duty charges on every “specified instrument” at the rate specified by the Minister by Order published in the Gazette.

8.2 Instruments liable to Stamp Duty

Some of the instruments liable to stamp duty are listed below.

- A receipt given to accept money or any other property
- A lease or hire of any property
- An affidavit;
- A policy of insurance
- A promissory note
- A transaction entered using credit card

Description	Rate (Rs.)
Any Affidavit	50.00
Any Policy of insurance for every Rs.1,000 or part thereof of the aggregate of the premia payable on the Policy	1.00
every credit card transaction- for every Rs.1,000 or part of thereof of such sum of money	25.00
Any promissory Note for every Rs.1,000 or part thereof	1.00
Any instrument relating to the lease or hire of any property	
For every Rs.1,000 or part thereof of the aggregate lease or hire including any premium, payable for the whole term comprised in the lease or hire Agreement (other than a hire purchase agreement) Provided that where the term of the lease or hire exceeds twenty years, the aggregate hire or lease payable for the whole term comprised in the lease shall be deemed to be the aggregate of the hire or lease payable for the first twenty years of such term;	10.00
For every Rs.1,000 or part thereof of the aggregate amount payable under a Hire Purchase Agreement entered into under the consumer Credit Act, No. 29 of 1982	10.00
Any Receipt or discharge given for any money or property	
Up to and including Rs.25,000.00	Exempt
Above Rs.25,000	25.00

8.3 Stamp Duty Rates

Example: Stamp Duty payments to Central Government

ABC (Private) Limited has 15 employees. Out of 15 employees, 12 employees have net salary over Rs.25,000. The balance 3 employees net salary is below Rs.25,000.

ABC (Private) Limited is liable to deduct Stamp Duty from employees and remitted to the Department of Inland Revenue as follows:

From 3 Employees with net salary is below Rs.25,000 = 3 employees * Rs. 0 = Nil

From 12 Employees with net salary is below Rs.25,000 = 12 employees * Rs. 25 = 300

Total Stamp Duty payable = 300

9. Stamp Duty payable to Provincial Council

9.1 Imposition of Stamp Duty by Provincial Council

The Provincial Councils are empowered to charge stamp duty on limited instruments (items).

9.2 Instruments liable to Stamp Duty

The provincial councils charge stamp duty in respect of the following:

- Every instrument (deed) relating to a transfer of immovable property (land) situated in the respective Province.
- Every document presented or filed in proceedings instituted in any Court of Law established by law, in the Province.
- Every transfer of a motor vehicle effected in the relevant Province.

9.3 Stamp Duty Rates for transfer of movable and immovable property

No	Description	Rate (Rs.)
1.	Gift or Deed of Gift of any property	
(a)	Where the value of the property is Rs.50,000/- or less for every Rs.100 or part thereof	3.00
(b)	Where the value of the property exceeds Rs.50,000/- for every Rs.100 of the value not exceeding Rs.50,000 And for every Rs.100 or part thereof of the value exceeding Rs.50,000	3.00 2.00
2.	Transfer or conveyance of any immovable property, other than gift	
(i)	Where the value of the property is Rs.100,000 or less for every Rs.100 or part thereof of the value	3.00
(ii)	Where the value of the property exceeds Rs.100,000 for every Rs.100 of the value not exceeding Rs.100,000 And for every Rs.100 or part thereof of the value exceeding Rs.100,000	3.00 4.00

Example: Stamp Duty

Mr. Perera sold a land in Western Province for Rs.3,000,000. The Stamp Duty payable is as follows:

First 100,000 of the value	=	$100,000/100*3$	=	3,000
Balance 2,900,000	=	$2,900,000/100*4$	=	<u>116,000</u>
Total Stamp Duty payable			=	<u>119,000</u>

CHAPTER ROUNDUP

- NBT should be paid by importers, manufacturers, service providers and wholesale and retail businesses.
- There are certain excepted articles and services.
- The turnover limit for registration of general businesses is Rs.3 million per any quarter from 01 April 2016.
- ESC should be paid by every person and every partnership on liable turnover.
- ESC liable threshold is Rs.12,500,000 per quarter for any quarter commencing from 01st April 2017.
- Stamp duty payable to Central Government and to Provincial Council.
- Central Government charge Stamp Duty on specified instruments.
- Provincial Council charges Stamp Duty on transfer of movable and immovable property.

PROGRESS TEST

- 1 **State** the turnover threshold for charging NBT for a general business for the period from 01st April 2019.
- 2 **State** how you calculate the NBT liability for a distributor.
- 3 **State** the deadline for submission of NBT returns.
- 4 **State** the turnover threshold to pay ESC for the period from 01st April 2019.
- 5 **State** the deadline for submission of ESC return.
- 6 Which one of the following is **NOT** a specified instrument for the purpose of stamp duty?
 - A. Promissory Note
 - B. Cheque
 - C. Any instrument relation to a lease
 - D. Credit Card transaction

ANSWERS TO PROGRESS TEST

- 1 Rs. 3 million per quarter from 01st April 2019.
- 2 3/4th (75%) of the turnover of a distributor is considered as nil and the balance 1/4th of the liable turnover is taxable at 2%
- 3 20th day of the following month (after end of each quarter)
- 4 Rs. 12.5 million per quarter from 01st April 2019.
- 5 20th day of the following month after end of the year of assessment
- 6 Cheque itself is not a specific instrument

Basic Income Tax Administration and Income Tax Payment Procedure

Knowledge Component

G. Basic Income Tax Administration and Income Tax Payment Procedure

7.1 Return of Income	7.1.1 State the circumstances under which an individual or a company is required to furnish a “return” with due dates. 7.1.2 State the consequences of non-compliance. 7.2.1 Identify self-assessment, default assessments, advance assessments, amended or additional assessments and circumstances leading to such assessments.
7.2 Assessments	7.2.2 Identify time bar periods applicable for each types of Assessments.
7.3 Objections and Appeals	7.3.1 State requirements and procedure for an Administrative review. 7.3.2 Explain the procedure for appeal to the Tax Appeals Commission (TAC). 7.3.3 Explain the circumstances for appeals for TAC.
7.4 Payment of tax and recovery of tax in default	7.4.1 Explain the liability to settle income tax on a ‘self-assessment’ basis, including due dates and calculate tax payable by installments. 7.4.2 Explain penalties applicable on the non/late payment of tax. 7.4.3 List recovery actions available under the Inland Revenue Act.
7.5 Withholding by Employers	7.5.1 Explain characteristics of Pay As You Earn (PAYE) system. 7.5.2 Explain the obligations of an employer under PAYE.
7.6 Withholding from investment returns	7.6.1 Identify payments subjected to WHT and relevant rates. 7.6.2 Explain withholding tax applicable for partnership. 7.6.3 Identify exemptions from withholding tax.
7.7 Withholding from service fees and contract payments	7.7.1 Identify payments subjected to WHT and relevant rates. 7.7.2 Identify exemptions from withholding tax.
7.8 Other matters relevant to withholding tax	7.8.1 Explain compliance requirements under WHT system. 7.8.2 Identify final withholding payments. 7.8.3 Explain tax credits for non-final withholding tax paid.

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1. Return of Income
2. Assessments
3. Objections and Appeals
4. Payment of tax and recovery of tax in default
5. Withholding by Employer
6. Withholding from investment returns
7. Withholding from service fees and contract payments
8. Other matters relevant to withholding tax

LEARNING OUTCOME

- 7.1.1, 7.1.2
 7.2.1, 7.2.2
 7.3.1, 7.3.2, 7.3.3
 7.4.1, 7.4.2, 7.4.3
 7.5.1, 7.5.2
 7.6.1, 7.6.2, 7.6.3
 7.7.1, 7.7.2
 7.8.1, 7.8.2, 7.8.3

1. Return of Income

- Every person who is liable to furnish a return of income for any Year of Assessment (Y/A) (unless already registered), is required to register with Commissioner General of Inland Revenue (CGIR) not later than 30 days after the end of the basis period for that year by submitting the specified application for registration and necessary information as required by the CGIR. Failure to register will lead to a penalty not exceeding Rs.50,000/-.
- Based on the application, CGIR will assign a Taxpayer Identification Number (TIN). Further CGIR may assign a TIN no. to a person who is not a taxpayer but makes payments which are subject to tax in the hands of the recipient or who is required to file a return.

1.1 Requirement to file returns – Individual

- Every person chargeable with income tax is required to submit a return of income to the Department of Inland Revenue.
- As per section 93 of the Inland Revenue Act, every person chargeable with income tax for any Y/A should furnish a “return” to the Department of Inland Revenue (DIR) not later than eight months from the end of the Y/A . For example, the income tax return for the year of assessment 2018/2019 should be submitted on or before 30 November 2019. It means after the end of the year of assessment, at any time prior to November 30 of the following year of assessment, return can be furnished.
- A “return” is a form specified by the CGIR. It should be furnished in the manner and containing the particulars specified by the CGIR, and it can be submitted either in writing or electronic form. In terms of the law, this return results in a self- assessment. Therefore, the return is known as self-assessment return.
- The return should be submitted with the following details.
 - (a) (i) the person’s assessable income for the year from each employment, business, investment and other sources;
 - (ii) the person’s taxable income and the tax payable for the year
 - (iii) any tax paid for the year by withholding, instalment or assessment for which a tax credit is available,
 - (iv) the amount of tax remaining to be paid for the year ,and
 - (v) any other information that the Commissioner General may specify;

(b) have to attached-

- (i) any withholding certificates, ; and
- (ii) any other information that the Commissioner General may specify.

1.2 Filing a return not required

- A return of income for a year of assessment is not required to be furnished by,
 - a resident individual who has no tax payable for the year on taxable income.
 - a resident individual whose tax payable for the year relates exclusively to income from employment subject to withholding under the PAYE scheme.
 - a non-resident person who has no tax payable on taxable income.
- However, the Commissioner General may serve a notice in writing on a person requiring the person to file a return or else a person may elect to file a return even though the person is not required to file a return.

1.3 Extension of time to file the tax return

- The CGIR may extend the time limit specified for filing a tax return. By granting time to file the return will not affect the due date of payment unless an extension is given by the CGIR for payment too.

1.4 Failure to file the return

- If it appears to the CGIR that any person who is liable to furnish a return has not done so, CGIR serve a notice requiring such person to furnish a return within the time given but not less than 14 days from the date of service of such notice. This does not mean that the time limit given to file the return i.e. eight months from the end of the year of assessment has been extended.

1.5 Penalty for Failure to file a return on time

- Noncompliance to the law will lead to serious penalties. As per section 178, penalty for a failure to file a return on time is the higher of;

5% of the amount of the tax owing and further 1% of the amount of tax owing for each month (or part thereof), and

Rs.50,000/- and further Rs.10,000/- for each month (or part thereof)

However, the maximum penalty chargeable is Rs.400,000/- (which should be imposed

through assessment by CGIR). This penalty is in addition to the tax liability, and may be assessed and collected in the same manner as the tax due for the period but not paid.

1.6 Application for making an amendment to the self-assessment Return

- A taxpayer who has filed a self-assessment return may apply to the CGIR for amending the self-assessment return within the period of 30 months, and in that regard, he needs to state reasons for amendments.
- CGIR may make a decision to amend or may refuse. When the CGIR make a decision to amend, the amended assessment should be made within 30 months from the date of self-assessment.
- When the CGIR decided to refuse, CGIR has to serve the written notice to the taxpayer with the reason for the decision.
- If the CGIR has not made a decision on an application within 90 days, the CGIR shall be deemed to have made a decision to disallow the application, and served the Taxpayer with notice of the decision on the ninetieth day after the application was filed.

1.7 Additional Return

- An Assistant Commissioner (ACIR) may require a person to file additional returns for a tax period even if the taxpayer has not filed a return for the period. To file this additional return, notice in writing should be sent requiring the taxpayer to send the return within a period of not less than 7 days.

1.8 Return on capital gain

- Every person with taxable income consisting of a gain from the realisation of an investment asset should file a capital gains tax return not later than one month after that realisation.

1.9 Calling for further information

- An Assistant Commissioner may require from the taxpayer and a Commissioner may require from any other person by giving reasonable notice in writing
 - to furnish any information, including information concerning another person.
 - to appear at the time and place designated in the notice.
 - to produce within the time specified in the notice, all documents in the person's custody or under the person's control relating to the person's or any other person's tax affairs as specified in the notice.
- A Commissioner may require any bank,

- to furnish any banking account or other assets which may be held on behalf of any person , or copy of bank statements, or
- to permit the Commissioner or Assistant Commissioner to inspect records of the bank with respect to banking account, or
- to furnish annually a schedule showing the amount of interest paid on deposits together with the names and address of such persons.

2. Assessments

As per the IR Act, there are four types of assessments.

- Self-Assessment
- Default assessment
- Advance assessment
- Amended / additional assessments

2.1 Self-Assessment

- A self-assessment taxpayer who has filed a self-assessment return in the approved form for a tax period including nil return is treated as having made a self-assessment.
- Where a self-assessment taxpayer has filed a proper return declaring a loss, he is treated as having made an assessment of the amount of loss set out in the return.
- A tax return completed and filed in writing or electronically should be a self-assessment return.

2.2 Default Assessments

- Where a taxpayer has failed to file a tax return for a tax period, the Assistant commissioner of inland revenue(ACIR) may make an assessment based on the evidence as may be available and to the best of his judgment, including a nil amount.
- Despite the default assessment, taxpayer is required to file the return.
- A tax return filed by a taxpayer after a default assessment is not a self-assessment return.

2.3 Advance Assessments

- An advance assessment can be made before the due date of the tax return, and if the tax is collected by assessment.
- An ACIR may issue an advance assessment with evidence available with him for a tax period, and in terms of the law prevailing at that time.
- An advance assessment is subject to an amended assessment.
- Despite the advance assessment, taxpayer is required to file the return.

2.4 Amended or Additional Assessments

- ACIR may amend an original assessment (self-assessment, default assessment or advance assessment) by making alterations or additions based on evidence available.
- In the case of a loss carried forward , correct loss will be assessed
- In any other case, liable for the correct amount of tax payable including a nil amount payable will be assessed in respect of the period to which the original assessment relates.

2.5 Communication in writing on the assessment

- When above assessments are issued, Assistant Commissioner should serve a notice in writing specifying the amount of the tax assessed, penalty, late payment interest , tax period to which the assessment related and date of due payment and the manner of objecting to the assessment. etc.

2.6 Time bar for assessment

- The statutory time limit within which an assessment should be made is known as the time bar for assessment.

- **Default Assessment**

- A default assessment can be made at any time.

- **Amended Assessment**

- Amended assessment can be issued at any time in the case of willful neglect by, or on behalf of, the taxpayer
- In any other case , it has to be issued within thirty months of
 - for self-assessment, the date that the self-assessment taxpayer filed the self-assessment return
 - for any other assessments, i.e. default assessment or advance assessment, the date on which the ACIR served the notice of the assessment on the taxpayer.

- **Additional Assessment**

- ACIR may further amend the original assessment to which the amended assessment relates within the later of,
 - (a) Four years after,
 - for self-assessment, the date that the self-assessment taxpayer filed the self-assessment return
 - for any other assessments, i.e. default assessment or advance assessment, the date on which the ACIR served the notice of the assessment on the taxpayer.

OR

- (b) One year after the ACIR has served the notice of the

amended assessment on the taxpayer.

In the case of above (b) ACIR cannot issue the amended or additional assessment on any other issue other than the issue in the amended assessment.

Example

Amended Assessment for 2018/19 - If a return is furnished on due date:

Assume that a person has duly submitted a return for the year of 2018/19, and it was submitted on 30th November 2019. No assessment can be made after 30th May 2022.

Additional Assessment on a self-assessment return for the Y/A 2018/19

Assume that self-assessment return was filed on 30th November 2019. Amended assessment was issued to the self-assessment on 30th August 2021. Time bar for the additional assessment is on or before 30th November 2023.

Additional assessment on a default or advance assessment issued for 2018/19

Assume that notice on a default assessment / advance assessment was issued on 9th of May 2020. Amended assessment was issued to the default/advance assessment on 15th of August 2021. Time bar for additional assessment is on or before May 08, 2024 or 14th of August 2022 whichever is later. That means, on or before May 08, 2024.

3. Objections and Appeals

- Unless provided in the Act, no decision relating to the payment of a tax under the IR Act should be disputed at the Tax Appeals Commission, any Court or Tribunal or any other proceedings on any other grounds. The amounts and particulars of every assessment made by the CGIR should be treated as correct and the liability of the taxpayer should be determined accordingly.

3.1 Administrative Review

- A taxpayer who is dissatisfied with an assessment or other decision may request the Commissioner General to review the decision.
- If the request is an objection against an assessment in the absence of a return, the notice of request relating to the objection should be sent with a return duly made.
- A request for review must be made to the Commissioner General in writing not later than thirty days after the taxpayer was notified of the decision. However, if the request has not been made within 30 days, he can submit a request after the lapse of 30 days period after

satisfying the CGIR that owing to absence from Sri Lanka, sickness or other reasonable cause the taxpayer was prevented from making a request,

- The request must specify in detail the grounds upon which it is made.
- The Commissioner General must acknowledge every request within 30 days from its receipts.
- The date of the acknowledgement of such request is the date of the request.
- A request for administrative review of an assessment does not suspend the collection of tax unless the CGIR grants an extension of time.
- Consider the taxpayer's request and notify the taxpayer in writing of the Commissioner General's decision and the reasons for the decision.
- A tax official other than the tax official who made the assessment or decision should consider taxpayer's request.
- The CGIR should take a decision by confirming the assessment, making an amended assessment, or an additional assessment or taking such other action to give effect to that decision.
- If no request is made within 30 days for administrative review, an assessment should be treated as final, subject to the right of the CGIR to issue a new or revised assessment.
- If an assessment is treated as final, and taxpayer timely files an amended return with the approval of the CGIR, the filing of the amended return has the effect of revising the assessment. He can file an amended return if the tax shown on the amended return exceeds the tax assessed.

3.2 Appeal from Administrative Review to the Tax Appeals Commission (TAC)

- An appeal to the TAC cannot be made unless a request for administrative review has first been made, and a decision has been received from the Commissioner-General or no decision has been received within ninety days from the date of request for administrative review was made.
- A person aggrieved by the decision of administrative review may appeal against the decision to the TAC within 30 days of the CGIR's decision.
- On reasonable valid grounds i.e. out of Sri Lanka, sickness, etc. taxpayer can obtain an extension of time to appeal.
- A taxpayer has appealed to the TAC of an assessment does not suspend the collection of tax unless the CGIR grants an extension of time.

- the Appellant is overcharged, TAC will reduce the amount of the assessment by the over charged amount or:
- if the Appellant is under charged, TAC will increase the amount of the assessment by the under charged amount or
- Confirm or annul the assessment.

If appeal Commission is satisfied that the tax in accordance with the decision of the appeal may not be recovered, TAC may require the Appellant to furnish security for payment of tax.

3.3. Appeal to the Court of Appeal

- An appeal to the Court of Appeal cannot be made unless an appeal request to the TAC has first been made, and a decision has been received from the TAC or no response to the request has been received from the TAC within ninety days from the date of request to the TAC was made.
 - Either party dissatisfied with the decision of the TAC may, within one month of being notified the decision, file a notice of appeal with the Court of Appeal,
 - The party so appealing should serve a copy of the notice of appeal to the TAC.
 - The appeal to the Court of Appeal should be made only on a question of law.
 - Where an appeal is made from a decision of the TAC, it should provide a written statement of the decision, including a summary of the evidence, the TAC's findings of the facts and their conclusions on the points of law involved to the Court of Appeal.

4. Payment of tax and recovery of tax in default

4.1 Payment of tax

A person who needs to pay tax on the assessable income derives or expects to derive from a business or investment or from an employment where the employer is not required to withhold tax is required to pay tax by quarterly installments.

In the case of a person whose year of assessment is ending 31st March, he needs to pay tax on or before:

- 15th August
- 15th November
- 15th February
- 15th May of the succeeding year of assessment.

For an example, income tax liability for the year of Assessment 2018/2019 must be paid on or before:

- 15th August 2018
- 15th November 2018
- 15th February 2019
- 15th May 2019

As per the new IR Act, year of assessment could be twelve months period ending on some other date. In such a situation, the instalment should be paid on or before the 15th day after each three months period commencing at the beginning of each year of assessment.

Each instalment should be calculated according to the following formula, and the taxpayer is subject to file an estimated tax payable form. It should be at the first tax instalment. If he sees that estimated tax payable amounts need to be changed, he may submit a revised estimated tax payable form. However, the formula is same as earlier.

The formulae is $(A-C) / B$, where

'A' is the current estimated tax payable for the year of assessment;

'B' is the number of instalments remaining for the year of assessment including the current instalment; and

'C' is the sum of any

- (a) previous instalments paid during the year of assessment and paid prior to the due date of the instalment
- (b) withholding tax deducted up to the due date of the instalment that are included in calculating the income for the year; and
- (c) tax paid by a withholding agent when the relevant tax has not been deducted or the tax paid as withholder during the year but prior to the due date for payment of the instalment.

It is ruled by the CGIR that ESC credits, if any, can be deducted from the above outcome. If any **balance tax** due to be paid, it can be paid on or before 30 **September** of the following year of assessment.

4.2 Penalties and interest on payment of income tax

4.2.1 Penalties on late payment of income tax

- Failure to pay all or part of an instalment payment within 14 days of the due date, 10% of the unpaid tax is the penalty.
- Failure to pay all or part of a tax due for a tax period within 14 days of the due date, or by the due date specified in the notice of assessment, if later, 20% of the unpaid tax is the penalty.

- However, if CGIR has granted an extension of the time beyond due date, and paid the tax accordingly, he should not be liable to such a penalty, but interest is payable on the tax.
- If the tax is underpaid, due to an incorrect statement or material omission in the tax return which is a result of intentional conduct or negligence on the part of the taxpayer, penalty will be 25% of the underpayment. However, if the underpayment is higher than Rs.10M or 25% of the person's tax liability for the period, penalty will be 75% of the underpayment.

4.2.2. Interest on payment of income tax

- The purpose of interest is to compensate the government (or taxpayer in the case of refunds) for the loss in the time value of money resulting from late payment.
- Procedures for the payment, collection and dispute of a tax are applicable equally to interest relating to a tax.
- Taxpayer is liable to pay interest in addition to the penalties, and it should be calculated separately.
- If a person has paid interest and an amount to which the interest relates is found not to have been payable, the interest paid on that amount has to be refunded to the person.
- Interest on delayed tax payments has to be computed from the original due date of the tax disregarding any extension obtained from the CGIR.
- In the case of tax due under a revised assessment, interest has to be calculated from the original due date.
- The interest rate for payments is one and one-half per cent per month or part month, compounded monthly.
- Minister may vary the interest rate by order published in the Gazette.

4.3 Notice of tax in default and submission of objection

- CGIR will send a notice to the taxpayer demanding payment when a tax is not paid by the due date.
- If the taxpayer has not made the payment within 21 days after service the notice, taxpayer is in default, and action will be instituted on him to collect the tax unless there is a payment arrangement entered into with CGIR or taxpayer has been granted an extension of time to make the payment.
- This notice could be issued on withholding tax as well as on a third party who is required to pay tax under a notice issued to a third party debtor.

4.4 Recovery actions under Inland Revenue Act

- The Commissioner General of Inland Revenue could take the following actions to recover taxes, and he can take action under more than one provision if he believes that it is appropriate. However, action should be initiated within five years from the date of default.
- Take action before Court of competent jurisdiction.
- Seizure of property through a lien. A lien in favour of CGIR is created in that amount (Interest +penalty+ cost of collection) on all property belong to taxpayer. CGIR may file an action in the High Court to enforce the lien.
- The CGIR may cause Execution against taxpayer’s property if he has failed to pay tax within thirty days after service of the notice.
- Unless the CGIR has good reason to release the seized property, the property will be sold. The sales proceeds should apply first against the expenses of the recovery of the levy and sale, then against the liability for penalties & interest, and then tax. Excess should be returned to the taxpayer.
- Where a defaulter is about to or likely to leave Sri Lanka without paying the tax in default, taxpayer can be prevented from leaving Sri Lanka by issuing a direction to Inspector General of Police through the Magistrate Court who then issue a direction to the controller of Immigration and Emigration.
- Where a government department, institution, or Ministry is about to make a payment to any defaulter, person (other than salary and wages) that department may apply such amount in respect of default tax and will notify the defaulter accordingly.
- CGIR may serve a notice in writing on a third party debtor. The third part debtor should remit such moneys to the CGIR.
- Where the CGIR has reasonable cause to believe that the taxpayer will not pay the tax due, CGIR may make an *ex- parte* application to the District Court requesting for an “Asset preservation order” to preserve the Assets and prohibiting any person holding, controlling or managing assets belonging to the taxpayer.

Withholding Tax

Division II of the Inland Revenue Act deals with tax payable by withholding tax.

“**withholding agent**” means a person required to withhold the tax from a payment under the Act.

“**withholdee**” means a person receiving or entitled to receive a payment from which tax is required to be withheld under the Act.

5. Withholding tax by Employer

Income tax payable by an employee on his employment income is deducted by the employer from the salary of the employee at the time the remuneration is paid or credited, and tax so deducted is remitted to the Department of Inland Revenue.

5.1 Requirements of an Employer

- Deduct WHT on employment income at rates specified by the Commissioner General (i.e. PAYE Tax Tables).
- Remit the taxes deducted in any month on or before the 15th of the following month.
- Issue a withholding tax certificate on tax deduction to the employees on or before 30th of April immediately succeeding the end of the year of assessment or within 30 days from the cessation of employment if the employee has ceased his employment.
- Maintain proper records on the specified forms in respect of each employee who is liable to tax.
- In this regard, a gazette notification No. 2064/60 dated 01st April 2018 has been issued by the Commissioner General

5.2 Primary employment

- An employer is required to collect primary employment declaration.
- An employee is required to furnish a declaration nominating his employer as the primary employer for a year of assessment.
- Based on that, employer is required to deduct tax by applying PAYE Tax Tables.
- If no primary employment declaration is collected, employer has to apply the Table 7.

5.3 Secondary Employment

- An employee shall furnish to an employer, with a declaration nominating the employment as the employee's primary employment except any employee who is having one employment. With respect to an employee, Secondary Employment means any employment that is not the primary employment of the employee.
- The second employer/s should deduct tax at the appropriate rate given in PAYE Table no. 7 as given below:

- Where the total monthly remuneration is less than or equal to Rs.50,000 per month, tax is deductible at 10%. On the balance amount exceeding LKR 50,000 per month, at 20%.

5.4 Submission of the Annual Declaration by the Employer

- Furnish annual declaration on or before the 30th of April every year.
- It should contain the name, employment number and national identity card number of each employee, whether the employer is a primary employer or a secondary employer with respect to such employment, payments made by the employer during the year and the amount of tax withheld from the payments.
- Schedules should be uploaded using e-Service or in soft form when the number of records in a schedule exceeds 20 and when less than 20 records such schedules may be uploaded by using e-Service or may be furnished as hard copies.

6. Withholding tax from investment returns

- Investment income is subject to withholding tax, and there are certain rules applicable for payer of the income and the recipient of the income as withholding agent and withholder respectively.
- Since investment income is subject to withholding tax, it is important to familiar with the withholding provisions. With regard to specific rules relating to each investment, it is separately explained under each investment heading, if applicable.

Special Rules applicable for withholding tax

- Every withholding agent is required to pay to the CGIR within fifteen days after the end of each calendar month any tax that has been withheld during the month.
- Every withholding agent should file with the CGIR within thirty days after the end of each year ending on the thirty first day of March an annual statement setting out the following:
 - (a) payments made by the agent during the period that are subject to withholding under the Act;
 - (b) the name, address and tax identification number of the withholder;
 - (c) tax withheld from each payment; and
 - (d) any other information that the Commissioner General may specify.
- The circular issued in this regard by the CGIR has mentioned that information should be given on payments on which no WHT has been made.
- A withholding agent who fails to withhold tax in accordance with the Act should however pay the tax that should have been withheld in the same manner and at the same time as tax that is withheld.

- If WHT has not been deducted, but respective WHT is paid by the withholding agent or paid by the withholder within 15 days after the end of the calendar month in which the payment is received, it is treated as withholding payment, then it will be considered as having paid by the withholder. In such a situation, final withholding treatment or tax credit treatment is applicable.

7. Withholding tax from service fees and contract payments

- Where a person pays a service fee with a source in Sri Lanka to a resident individual who is not an employee of the payer, withholding tax needs to be deducted at the rate of 5% on amounts exceeding Rs.50,000 per month. This is not a final tax, hence after applying the appropriate rate, WHT can be claimed as tax credit.
- As per the law, the “service fee” means a **payment** to the extent to which, based on market values, it is reasonably attributable to services rendered by a **business** of a person, but excludes interest, rent or a royalty.

Withholding tax is not applicable

- when payments are made by individuals who are not conducting a business;
- payments that are exempt amounts under section 9
- payments of service fees in respect of which a certificate is presented by the recipient confirming that the payments are chargeable with the Economic Service Charge
- **payment**” means the conferring of value or a benefit in any form by one person on another person and includes–
 - (a) the transfer by one person of an asset or money to another person or the transfer by another person of a liability to the one person;
 - (b) the creation by one person of an asset that on creation is owned by another person or the decrease by one person of a liability owed by another person;
 - (c) the provision by one person of services to another person; and
 - (d) the making available of an asset or money owned by one person for use by another person or the granting of use of such an asset or money to another person.

The following services are subject to withholding tax.

- (e) Teaching, lecturing, examining, invigilating or supervising an examination;
- (f) A commission or brokerage to a resident insurance, sales or canvassing agent ;
- (g) An endorsement fee

- (h) Fee in relation to the supply of any article on a contract basis through tender or quotation;
- (i) Other matters as may be prescribed by regulation. The CGIR has issued a **Gazette Notification No. 2064/51 dated 01st April 2018**, and the following services have been mentioned.
- (j) Any service provided in the independent service providers such as doctors, engineers, accountants, lawyers, software developers, researchers, academics or any other similar service.
- (k) Any service of construction work, security service, janitorial service, consultants work of any kind, organizing of events, catering, designers, dress makers, tour guidance, entertainment, agency functions or any similar service or connected work where such service are provided under an agreement or otherwise.
- (l) Any management service.
- (m) Any type of vocational services provided as an independent service provider.
- (n) Payments made to non-resident persons which are subject to withholding tax if the payment or allocation has a source in Sri Lanka.

8. Other matters relevant to withholding tax

8.1 Compliance requirements under WHT system

Listed below are the key compliance requirements of a Withholding Agent:

- Identification of payments, which are liable to withholding tax under the provisions of the Inland Revenue Act;
- Withhold tax, as per the tax rates specified in Part 10 of the First Schedule of the Inland Revenue Act at the time of making or crediting such payments, and remit such taxes withheld to the Department of Inland Revenue on or before the 15th of the following month;
- Provide a Withholdee with a monthly WHT certificate not later than 30th day of the subsequent month. The WHT certificate must be in the specified form and contains the amount of payments made to the withholdee and the amount of tax withheld during each calendar month;
- Maintain proper record of payments in a manner facilitating to issue withholding tax certificates and to prepare annual statement with relevant Schedules.
- File an ‘Annual Statement’ along with relevant schedules and information with the Department of Inland Revenue on or before 30th April following the end of the Year of Assessment;

8.2 Identify final withholding payments

The withholding taxes deducted in the following instances are considered as final withholding for the purpose of the Inland Revenue Act and there are no credits available for such taxes withheld.

- dividends paid by a resident company to another resident person;
- interest paid to or treated as being derived by a resident individual (other than the interest paid to a senior citizen falling within the tax relief threshold) and a charitable institution;
- amounts paid to winnings from lottery, reward, betting or gambling, other amounts received in conducting a business consisting of betting and gaming; and
- payment made to non-resident persons other than payments derived through a Sri Lankan permanent establishment.

8.3 Explain tax credits for non-final withholding tax paid

- The WHT payment, which is not final WHT, can be claimed as a tax credit. A withholder is entitled to a tax credit in an amount equal to the tax treated as paid for the Year of Assessment; in which payment is derived.

CHAPTER ROUNDUP

- Every person liable to tax is required to submit a return of income on or before the expiry of eight months from the end of a year of assessment.
- Every person who is liable to furnish a return of income for any Y/A (unless already registered), is required to register with CGIR and submit a return of income.
- Default Assessments, advance assessments, amended assessments or additional assessments can be issued by the Department of Inland Revenue. For issuing amended assessments or additional assessments, the time bar period should be taken into account.
- Request for administrative review should be filed within 30 days from the date of notice of assessment received against any assessment by the taxpayer.
- Taxes should be paid via quarterly installments and in that regard, estimated tax payable form needs to be submitted.
- Late payments of quarterly installments and other tax payments are subject to penalties and interests.
- The Department of Inland Revenue can enforce more than one means for recovery of default taxes.
- Withholding tax is applicable on employment income, investment income, and certain service income. Certain withholding taxes are considered as a final tax.

PROGRESS TEST

- 1 Under which conditions, an individual is not required to submit a return of income.
- 2 Mr. Silva submitted his personal return of income for the Y/A 2018/2019 on 30 November 2019.

State the last date on which an Assistant Commissioner can issue an amended assessment for that Y/A.

- 3 Which one of the following is NOT a requirement for making a request for an administrative review?
 - A Request should be made within 30 days after the tax payer was notified the decision.
 - B In the absence of a return, a request should be made together with the return
 - C Request should specify in detail the grounds upon which it is made
 - D Tax as per assessment should be paid in full
- 4 Department of Inland Revenue can recover tax in default from third parties. **Identify** the third party which cannot be included in this category.
 - A Debtor of the defaulter
 - B Bank who has deposit of the defaulter
 - C Employer of the defaulter
 - D Father of the defaulter

ANSWERS TO PROGRESS TEST

- 1 An individual who has no taxable income and an employee who has paid taxes on employment under the PAYE Scheme.
- 2 30th May 2022
- 3 D , tax as per assessment should be paid in full
- 4 D, Father of the defaulter

Taxation of other Persons & Entities

Knowledge Component

H .Taxation of other persons & entities

8.1 Bodies of persons	<p>8.1.1 State the interpretations of the following terms for tax purposes: body of persons, charitable purpose and charitable institution.</p> <p>8.1.2 Explain the chargeability to income tax from charitable institutions and non-governmental organisations.</p> <p>8.1.3 Assess the tax liability of a charitable institution and non-governmental organisation.</p> <p>8.1.4 Calculate the taxable income of a partnership, tax payable by a partnership, distribution of partnership income among partners, and taxes of individual partner.</p>
8.2 Trustees, executors and receivers	<p>8.2.1 Explain the meaning of the terms executor, trustee and receiver.</p> <p>8.2.2 Assess income tax liability of a person in the above capacities.</p>

CHAPTER CONTENTS

1. Bodies of persons
2. Trustees, executors and receivers

LEARNING OUTCOME

- 8.1.1, 8.1.2, 8.1.3, 8.1.4.
8.2.1, 8.2.2

1. Bodies of Person**1.1 Interpretations as per the Inland Revenue Act**

Body of persons means a company, partnership, trust or other body of persons, whether formed in Sri Lanka or elsewhere.

Charitable Institution means the trustee or trustees of a trust or corporation or an unincorporated body of persons established for a **charitable purpose** only or engaged solely in carrying out a charitable purpose.

Charitable purposes means a purpose for the benefit of the public or any section of the public in or outside Sri Lanka, of any of the following categories:

- the relief of poverty;
- the advancement of education or knowledge other than by any institution established for business purposes or by any institution established under the Companies Act;
- activities for the protection of the environment or eco-friendly activities;
- the advancement of religion or the maintenance of religious rites and practices or the administration of a place of public worship;
- Any other purpose beneficial to the community, not falling within any of the above categories.

1.2 Chargeability and Computation the Income Tax liability**1.2.1. Charitable Institution**

- A charitable institution is deemed a person under the Act, and it is liable for income tax on any gains, profits or income, unless such gains, profits or income are exempt from income tax. Though a body corporate could also be a charitable institution, in terms of the definition of charitable institution given in section 195 of the Act, the rules applicable to a company shall not apply to such charitable institution. Generally speaking, since charitable institutions are defined as “persons”, they are subject to the same tax rules as applicable to other types of persons.
- As per section 6 of the First Schedule, the tax rate of a charitable institution is 14%; however, gains from the realisation of investment assets are taxed at 10%.

1.2.1.1 Assessable Income of a charitable institution

- The assessable income of a charitable institution is arrived after excluding the following:

a). Final withholding payments

When the Interest is received by the charitable institution, and withholding tax has been deducted on such interest at the rate of 5%, such interest paid to, or treated as being derived by a charitable institution, shall be a final withholding payment, as provided in section 88 (1)(b)(ii) of the Act.

b). Exemptions

- Interest derived by a charitable institution that is applied for the purpose of providing care to children, the elderly or the disabled in a home maintained by that charitable institution may be exempt if approved by the Commissioner-General (Third Schedule, (i)).
- Profits and income from any property donated royal proclamation or other grant before March 2, 1815 to any place of workshop if it is used for the original purposes may be exempt (Third Schedule, (q)).

1.2.1.2. Taxable Income of a charitable institution

- Offertories, subscriptions and donations received by the charitable institution are not liable to tax, if it is an approved charity or is not considered as non-governmental organization.
- A charitable institution is not entitled to deduct the tax-free allowance of Rs.500,000 from the assessable income in computing the taxable income.
- In arriving at the taxable income of a person, qualifying payments can be deducted. If the charitable institution has made any donation to an approved charity or to the government, the rules with regard to deductibility of qualifying payments are applicable to the charitable institution since it is also deemed a “person”.

1.2.2. Non-governmental organizations

As per section 195, “**non-governmental organization**” means any organization or association, whether incorporated or unincorporated, formed by a person or a group of persons on a voluntary basis and which is non-governmental in nature, and established and constituted -

- (a) for the provision or relief and services of a humanitarian nature to the poor and destitute, the sick, orphans, widows, youth, children; or
- (b) generally, for the provision of relief to the needy, unless such organization or association is determined by the Commissioner-General not to be a non-governmental organization, but, in all cases, does not include an approved charity;

1.2.2.1 Chargeability of Income Tax

- A non-governmental organization would be “a person” for the purposes of income tax. In the generality of cases, non-governmental organizations are not profit oriented entities and, therefore, they are not engaged in carrying on trading or business activities
- However, such organizations may have income from investments, such as interest and dividends, which would normally be liable to tax.
- Chargeability would also arise on receipt of on any money in the form of a grant, donation, contribution or in any other manner.

1.2.2.2. Rate of tax

- Where a non-government organisation (NGO) receives in any year of assessment amounts by way of grant, donation or contribution or in any other manner, an amount equal to 3% of such aggregated amounts received shall be deemed to be the income of the NGO and shall pay tax at 28% on such income as set out in the First Schedule.
- On any other taxable income (apart from grants and donations) tax is payable at 14% if such non-governmental organization has a charitable purpose; if not, the rate is 28%.
- Any interest received by the non-governmental organization is treated as final withholding payments if withholding tax has been deducted at the rate of 5%.
- Where a non-governmental organization's taxable income includes gains from the realisation of investment assets, then those gains shall be taxed on the non-governmental organization at the rate of 10%.

1.2.2.3. Reduction or removal of tax by the Commissioner General

- Where the Commissioner-General is satisfied that any non-governmental organization is engaged, in any year of assessment, in -
 - (a) rehabilitation and the provision of infrastructure facilities and livelihood support to displaced persons in any area identified by the Government for the purposes of such rehabilitation and provision; or
 - (b) any other activity approved by the Minister as being of humanitarian in nature, taking into consideration the nature and gravity of any disaster and the magnitude of relief required to be provided consequently,

the Commissioner-General may reduce or remove the tax payable by such non-governmental organization for that year of assessment if it appears that such reduction is just and equitable in all the circumstance of the case.

1.3 Computation of the taxable income of a partnership

A partnership is included in the definition of “entity”, and given that an entity is, for tax purposes, treated as a “person”, a “partnership” is also deemed a taxable person. When the number of partners is more than 20, then the partnership is considered as a company.

1.3.1. Specific provisions applicable to a partnership

- There are certain specific provisions applicable for a partnership, specified in sections 53, 54, 55 and 56 of the Act.
- The provisions applicable to a person in determining income, gain or profits are applicable to a partnership as well, since a partnership is considered as a person.
- Income of a partnership for a year of assessment should be the partnership’s income from its business or investment as per sections 6 and 7 of the Act.

1.3.2. Determining the income, gain or profits of the partnership

- Amounts derived, and expenditure incurred, in common by partners should be treated as amounts derived or expenditure incurred by the partnership and not by the individual partners.
- All business activities of a partnership shall be treated as conducted in the course of a single partnership business.
- Assets owned, and liabilities owed in common by partners should be treated as assets owned or liabilities owed by the partnership and not by the partners and should be treated as –
 - (a) in the case of assets, acquired when they begin to own such assets in that way;
 - (b) in the case of liabilities, incurred when they begin to owe such liabilities in that way; and
 - (c) realised when they cease to be so owned or owed in that way.
- Arrangements between a partnership and its partners should be recognised and the following should be taken into account in determining a partner’s share:
 - (a) loans made by a partner to a partnership and any interest paid in that respect, and

(b) services provided by a partner to a partnership (including by way of employment) and any service fee or income from employment payable in that respect.

- No deductions are allowed for partners' salaries, interest on capital or any other benefit
- "Partner's share" should be equal to the partner's percentage interest in any income of the partnership as set out in the partnership arrangement.

1.3.3. A loss incurred by a partnership

- A loss incurred by a partnership for a year of assessment shall be the partnership's loss from its business or investment for the year; if there is any loss from realisation of investment assets, such loss should not be set off against any profits on the disposal of another investment asset.
- When the partnership incurs a loss, such loss will be allocated to the partners in their profit-sharing ratio.

1.3.4. Payment of Income tax by the partnership

- Partnerships are not required to pay income tax on their taxable income, and therefore, a partnership is not entitled to claim withholding tax credits. However, a partnership is liable to pay tax at the rate of 10% on the gains from the realisation of an investment asset.
- Though the partnership is not required to pay tax, it is required to act as a withholding agent when distributing the share of profits to its partners. A partnership is required to deduct withholding tax **at the rate of 8%** when distributing the share of profits of the partnership.
- The precedent partner or in the absence of such partner in Sri Lanka, an agent of the partnership in Sri Lanka, should withhold such withholding tax.
- Tax paid under the provisions of the Act and foreign income tax paid or treated as paid by the partnership with respect to the partnership income should be allocated to the partners, proportionately to each partner's share, and should be treated as paid by them. The allocation occurs at the time partnership income is treated as derived by the partners.

- As and when any other payments are to be made to other persons and which are subject to withholding tax, the partnership is required to deduct withholding tax as provided in the Act.

1.3.5. Gains from the realisation of investment assets

- When the partnership's taxable income includes a gain from the realisation of an investment asset, then tax at 10% has to be paid by the partnership itself.

1.3.6. Payment of income tax by partners

- The partners have to pay tax, as individuals, on their respective share of profits from the partnerships and other income, if any.
- This share of profits includes salaries, service fees paid or other benefits provided to partners, and any interest paid to them in respect of loans given to the partnership.
- If the partner is a partner of many partnerships, in calculating his income for a year of assessment, the partner's share of any partnership income should be included or the partner's share of loss should be deducted. It should be deducted in the relevant partnership year. The relevant partnership year is the year of assessment of the partnership ending on the last day of, or during, the year of assessment of the partnership.
- Partners are entitled to claim tax credit proportionately on withholding tax paid by the partnership.

1.3.7. Change of Partners - from the partnership's point of view

- Where there is a change of partners in a partnership and at least two existing partners continue with the partnership, the partnership should be treated as the same entity both before and after the change.

- If any asset transfer occurs on a change of partners, it should be considered as a realisation by way of transfer of ownership of the asset by an entity to partners or *vice versa*. In that case, the transferor (partnership or partner, as the case may be) should be treated as deriving an amount in respect of the realisation equal to the market value of the asset immediately before the realisation, and the transferee (partnership or partner, as the case may be) should be treated as incurring expenditure of such amount in the acquisition.

1.3.8. Change of Partners - from the partners' point of view

- Gains on disposal of an interest of a partner in a partnership should be treated as income from a business and be included in calculating the income of the partner from the partnership.
- The calculation should be based on the consideration, cost and other provisions applicable for the calculation of the gain on realisation of assets.
- When calculating such gain from the partner's interest, there should be included in the cost of a partner's interest in a partnership amounts included in calculating the partner's income, at the time of the inclusion, and the partner's share of exempt amounts and final withholding payments derived by the partnership, at the time the amount or payment is derived.

2. Trustees, executors and receivers

2.1. Definitions / Meanings

- Executor is the person who is appointed to administer the estate of a deceased person, in accordance with the last will of such deceased person. He will be given probate by court to administer the estate and will be responsible for payment of any tax payable on the income of the estate.
- **Trustee** means an individual or body corporate holding assets in a fiduciary capacity for the benefit of identifiable persons or for some object permitted by law and whether or not-
 - (a) the asset is held alone or jointly with other individuals or bodies corporate; or

(b) the individual or body corporate is appointed or constituted trustee by personal acts, by will, by order or declaration of a court or by operation of the law; and

(c) includes,

- i. an executor, administrator, tutor or curator;
 - ii. a liquidator, receiver, trustee in bankruptcy or judicial manager;
 - iii. a person having the administration or control of assets subject to a usufruct or other limited interest;
 - iv. a person who manages the assets of an incapacitated individual; and
 - v. a person who manages assets under a private foundation or other similar arrangement.
- **“Receiver”** means a person who, with respect to an asset situated in Sri Lanka, is
 - (a) a liquidator of a company or other entity;
 - (b) a receiver appointed out of court or by a court;
 - (c) a trustee in bankruptcy;
 - (d) a mortgagee in possession;
 - (e) an executor, administrator, or heir of a deceased individual’s estate;
 - (f) conducting the affairs of an incapacitated individual; or
 - (g) a successor in a corporate reorganization.

2.2. Computation of income tax liability

Executor

- The executor is responsible for performing any duties or obligations imposed under the Act in respect of a deceased person in relation to his taxable income consisting of a gain from the realisation of an investment asset, including the payment of tax on that gain. (section 96(5))

- Where, after the death of a taxable person or the sequestration of a taxable person's estate, a taxable activity previously carried on by the taxable person is carried on by or on behalf of the executor or trustee of the person's estate or anything is done in connection with the termination of the taxable activity, the estate of the taxable person, as represented by the executor or trustee, is deemed for the purposes of this Act to be the taxable person in respect of the taxable activity. (section 146(14))
- Executor is not entitled for personal relief of five hundred thousand rupees for each year of assessment (Not provided for in Fifth Schedule).
- The rate of tax on the income of the estate on 24% (same as that for a trust).

Receivers

- Section 175 of the Act sets out provisions relating to Receiver.
- A receiver is required to notify the Commissioner-General of the receiver's appointment within fourteen days after being appointed.
- Commissioner-General may notify the receiver of the amount that appears to the Commissioner-General to be sufficient to provide for payment of tax owing, or that will become owing, by the person whose assets are in the possession or care of the receiver.
- A receiver may not dispose of an asset situated within Sri Lanka held in the receiver's capacity as receiver, without the prior permission of the Commissioner-General.
- A receiver must set aside out of the proceeds of sale of an asset the amount notified by the Commissioner-General, or a lesser amount as may be agreed with the Commissioner-General.
- A receiver is personally liable for the amount of tax to the extent of an amount required to be set aside, if the receiver fails to comply with the requirements of this section.
- Receivers is not entitled for personal relief of five hundred thousand rupees for each year of assessment.

- A receiver is chargeable to tax on the income of the properties under his control. The rate of tax is 24%. However when income, upon liquidation of a company is distributed to the shareholder, the amount distributable less the cost of the shareholder's investment in the company is considered as a dividend. (Please note that a dividend, by definition, excludes "a payment to the extent to which it is matched by a payment made by the member to the company").

Trust and Trustee

- A trust will be assessed to tax on its taxable income as an entity, separately from its beneficiaries where no entitlements are provided for the trust deed. The rate of tax is 24% on the trust income.
- Where entitlements are provided for, the shares of the income which the beneficiaries are entitled to shall be deducted from the amount of income of the trust and shall be considered as the income of the beneficiaries.
- A beneficiary will be liable to tax on his share of the trust income (other than gains on realisation of an investment on which the trustee is required to pay the tax at 10%) to which he is entitled to.
- In computing the tax liability of a beneficiary, the tax treatment applicable to an individual applies and the tax free allowance of Rs.500,000 is, accordingly, claimable.

CHAPTER ROUNDUP

- A charitable institution is deemed a person under the Inland Revenue Act and the section 6 of the First Schedule provide the applicable tax rate.
- A non-governmental organization would be “a person” for the purposes of income tax
- A partnership is not required to pay tax. However, on the share of profits of the partnership, withholding tax to be paid at the rate of 8%
- Executor and Receivers are not entitled for personal relief of five hundred thousand rupees and liable to tax at the rate of 24%
- A trust will be assessed to tax on its taxable income as an entity.

PROGRESS TEST

- 1 **Identify** which is not a charitable purpose as per the Inland Revenue Act
 - A. the relief of poverty;
 - B. the advancement of religion
 - C. the advancement of education by incorporating a private university
 - D. activities for the protection of the environment.

- 2 Who is **not a Receiver** as per the provisions of the Inland Revenue Act
 - A. a liquidator of a company;
 - B. a receiver appointed out of court;
 - C. a partner of a partnership
 - D. a trustee in bankruptcy;

- 3 **Identify whether an executor** is not entitled for personal relief of five hundred thousand rupees for a year of assessment?

- 4 Share of profits of A & B partnership is Rs 1,400,000. **Calculate** the withholding tax payable by the partnership. What is the correct answer out of below
 - A Rs. 32,000
 - B Rs. 80,000
 - C Rs. 60,000
 - D Rs. 112,000

ANSWERS TO PROGRESS TEST

- 1** A. the advancement of education by incorporating a private university
- 2** C. Partner of a partnership
- 3** No
- 4** The correct answer is A: Rs. 112,000

