Tax Alert

May 7, 2021

Government enacts tax amendments to the Inland Revenue Act, No 24 of 2017

The Inland Revenue (Amendment) Act was passed in Parliament on 4 May 2021 and is pending certification by the Hon. Speaker.

This Amendment Act brings into law the Government budget proposals which were announced in November 2020 and other announcements made in January 2020.

Most of these proposals have been brought to your attention through our previous publications.

This Tax Alert seeks to highlight key amendments introduced through the Amendment Act.

A 200% deduction for marketing and communication expenses

A double deduction can be obtained if the expenditure is incurred in marketing locally valued added products or services. The minimum local value addition that is expected is 65% and the method of calculating this value addition will be prescribed by the Commissioner General of Inland Revenue (CGIR).

A wide range of expenditure will be eligible for this double deduction which is defined in the law, including:

- Expenditure in advertising on mass media, social media and product launches;
- Market research expenses;
- The development of a advertising campaign in Sri Lanka; and
- The development and printing of point of sale material.

There are a few restrictions to curb any potential misuse of this additional deduction. The payments that would not qualify for this double deduction includes:

- Payments made to associated persons
- Payments made for internal marketing staff
- Payments made for corporate social responsibility (CSR) projects
- Payment of foreign travel expenses

The CGIR is to specify the documentation to be maintained by a person seeking this double deduction. The total deduction permitted herein will be limited to Rs. 500 million per year of assessment for a period of 3 years, from the year of assessment 2021/22.

This deduction is permitted for marketing and communication expenses, despite such expenditure being capital in nature.

Tax relief from thin capitalization rules

The thin cap adjustment will be suspended in the year of assessment 2021/22. As such there will be no add-backs during this year of assessment, even if the company is geared above the permitted limit.

Further, manufacturers can now borrow up to four times of their share capital and reserves, without being subjected to the thin capitalization add-back of interest/financial costs. This was previously limited to only three times the share capital and reserves.

Extended time period for new projects with an investment less than USD 3 million, to make use of enhanced capital allowances

The additional deduction by way of enhanced capital allowances which is available for new investments (other than expansions) with an investment of less than USD 3 million (indepreciable assets) is extended until the end of year of assessment 2023/24.

This enables a new undertaking to claim a 200% deduction for depreciable assets which are used in the project subject to meeting certain criteria.

The deduction of 200% for research and development expenses extended

The double deduction of 200% can be obtained for research and development expenditure for another two years, i.e., till the end of year of assignment 2022/2023.

Research and development expenses, as defined in the Act, include research expenses pertaining to upgrading a person's business and improving business products or processes.

Concessions for listing

A company which lists its shares between 1 January 2021 and 31 December 2021 is entitled for the following;

- Concessionary tax rate of 14% for 3 years commencing from 1 April 2022 (year of assessment 2022/2023)
- Income tax payable by the company in the year of assessment commencing from 1 April 2021 (year of assessment 2021/22) will be reduced by 50%

Will the new concessions help transform your business?

We highlight below noteworthy amendments that apply to specific industries.

Exporters and export oriented companies

Sale of health protective equipment

A concessionary rate of tax of 14% for an export company registered with the Board of Investments (BOI) on health protective equipment and products supplied to the following bodies;

- The Ministry of Health
- Department of Health Services
- Sri Lanka Army, Navy and Airforce
- Sri Lanka Police
- COVID Center

Import replacement

A concessionary rate of tax of 14% on the supply of goods manufactured in Sri Lanka by an export oriented company to the following;

- BOI companies
- SDP projects
- Any other person who is eligible for duty free concessions

The quantity which could be provided under this is to be approved by the BOI as an import replacement and is applicable for three years commencing from year of assessment 2021/22.

Export of goods

The concessionary rate of 14% applies only if the gains and profits received are in foreign currency and remitted to Sri Lanka though a bank. This is a new condition to qualify for the new rate and appropriate controls need to be implemented to ensure this condition is met.

The above concessionary rate applies to any sale of goods where the payment is received in foreign currency and remitted to Sri Lanka through a bank.

Services for payment in foreign currency

Exemption for any service rendered to a person to be utilized outside Sri Lanka if payment is received in foreign currency and remitted to Sri Lanka through a bank.

Hub services, warehousing and bunkering

Dividend tax exemption

Exemption for dividends received from an entity which has signed an agreement with the BOI under the Hub Regulations stipulated in the Finance Act. Accordingly, dividends distributed by such entities which are engaged in the following are exempted from dividend tax:

- Entrepot trade
- Offshore businesses involving the supply of goods entirely outside Sri Lanka
- Providing front end services to clients abroad
- Headquarters operations for leading buyers
- Logistic services including bonded warehousing

Concessionary rate of tax

The aforementioned services/hub services would also qualify for a concessionary rate of 14%, available for specified undertakings.

Exemption for warehousing

A new undertaking for letting bonded warehouses or warehouses related to the offshore business in Colombo and Hambantota Ports is exempted from income tax (if the investment is made after 1 April 2021).

Concession for bunkering

Concessionary rate of tax of 14%, as a specified undertaking, for bunkering services provided for the supply of marine fuel including the supply of marine fuel to local bunker suppliers within a specified port premises.

Construction

Concessionary rate of 14%

Gains and profits from providing construction services is taxed at 14%.

Use of recycled construction material

A new undertaking which is engaged in the sale of construction material which is recycled from material already used in the construction industry is exempted from tax for a period of 10 years.

If a person recycles and uses such material in his own construction services business, such goods will be deemed to be supplied at the market value and the profits from such deemed sale will be exempted from income tax for a period of 10 years.

Construction and installation of telecommunication towers

A resident person who constructs and installs telecommunication towers and related appliances using local labor and raw materials and technical services for such construction or installation is exempted for a period of 5 years. This exemption applies for a new undertaking commenced on or after 1 January 2021.

Agro Farming and Agro Processing

Agro farming

The sale of produce from agro farming is exempt for a period of 5 years from 1 April 2019

Agro farming means:

- *The tillage of the soil and cultivation of land with plants of any description*
- *Cultivation in green house*
- *Bee keeping*
- *Rearing of fish, shrimp farming*
- *Animal husbandry*
- *Poultry farming*
- *Hatchery, veterinary or artificial insemination services*
- *The cleaning, sizing, sorting, grading, cutting or chilling of any produce produced out of any activity referred to above in preparation of such produce for the market, excluding agro food processing*

Agro processing

Agro processing is taxed at a concessionary rate of 14%.

Agro processing means the processing of any locally produced agricultural, finishing, or animal product and includes an undertaking for the dehydrating, milling, packaging, canning for the purpose of changing the form, contour or physical appearance of such product in preparation for the market but excludes an undertaking of deep-sea fishing or manufacture.

The produce from agro farming is deemed to be sold for agro processing at the market rate. The profits and income from such deemed sale will be considered as exempt for a period of 5 years from 1 April 2019.

A 25% reduction in the tax payable is allowed on the agro processing component. This reduction is calculated based on the proportion of farming produce utilized in agro processing as a proportion to the total farming produce utilized in agro processing. This reduction of tax payable is available for a period of 5 years of assessments commencing from year of assessment 2021/2022.

Dairy producers

Accelerated depreciation (within 2 years) for expenditure incurred in acquiring milking machines with latest technology to manufacture local liquid milk related products.

Dairy producers

Manufacturers are taxed at a concessionary rate of 18%.

Manufacture means a change in a non-living physical object, article or thing-

- *Resulting in transformation of such object, article or thing into a new and distinct object, article or thing having a different name, character or use; or*
- *Bringing into existence a new and distinct object, article or thing with a different chemical composition or integral structure*.

Boat or ship manufacturing

A new undertaking for the manufacture of boats or ships is exempt from tax for 7 years.

Gem and jewellery

Exemption for export of gold, gems or jewelry or from the business of cutting and polishing gems which are brought to Sri Lanka and exported after such cutting and polishing, provided the profits in foreign currency are remitted through a bank of Sri Lanka, with effect from 1 April 2021.

Information Technology

Exemption for information technology and enabled services as may be prescribed.

Multinationals

A multinational company is a company that is a part of a group of associated companies, with business establishments in two or more countries.

Reduction in tax payable on dividend paid by multinationals;

- By 25% if export increased by minimum of 30% in year of assessment 2021/2022
- By 30% if export increased by minimum of 50% in year of assessment 2022/2023
- By 50% if export increased by minimum of 50% in year of assessment 2023/2024

Exemption from tax on interest income on any deposit opened and maintained in foreign currency in any domestic bank, if the deposit is maintained to cover its import expenditure for that year of assessment after 1 April 2021.

Renewable energy

Exemption for seven years for any renewable energy project with a capacity not less than 100 Megawatts of solar or wind power.

Concessionary rate of 14% for the supply of electricity to the national grid generated using renewable energy sources by a company.

▶ Small and Medium Enterprises (SME)

Widening the SME net

The SME concessionary tax rate of 14% can be claimed even if the person has other associated entity, provided, the aggregate annual gross turnover of the person and associate is less than Rs. 500 million.

Deductibility of losses

Losses incurred by a SME can be claimed against subsequent profits of the company even if subsequently tax is imposed at a different rate (eg- due to the entity no longer being a SME)

Tax relief measures

The CGIR shall write off any income tax arrears payable by any SME if such arrears arise due to any assessment made up to the year of assessment ending 31 March 2019 which is outstanding as at 26 June 2020 in relation to income tax.

▶ Banking and financial services

Exemptions

- Interest, discount or realization of any gain on any sovereign bond denominated in local or foreign currency, which is earned by a non-resident person
- Interest or discount on any sovereign bond denominated in foreign currency including Sri Lanka development bonds earned by any person is exempted. This exemption does not extend to any realization of any gain like in the case of a non-resident.
- Gain on realization of Sri Lanka International sovereign bonds issued by or on behalf of the Government of Sri Lanka and received or derived by a Commercial Bank or authorized dealer who made an aggregate investment not less than USD 100 million in such bonds after 1 April 2021

Deduction for specific provision

The Directives made by the Central Bank specifically exclude the right to receive a payment on deposits, debentures, stocks, treasury bills, promissory notes, bills of exchange and bonds. The above deduction also specifically excludes any directives issued in relation to the adaptation of Sri Lanka Accounting Standards.

Further, if a specific provision for a debt claim which has been fully claimed is revered, reduced or paid – such amount which is reversed, reduced or paid has to be included in calculating the income of the Bank.

Documentation in relation to specific provisions to be maintained in prescribed form.

Financial consolidation

Possibility of deducting the expenditure incurred by a financial institution by way of cost of acquisition or merger of any other financial institution. This expenditure should be confirmed by the Central Bank and can be deducted over a period of three years with a possibility of a carry forward of any unclaimed amount.

Deductibility of costs of providing loans to individuals who have completed vocational education from certain institutions

The costs of funds of a financial institution on providing the aforementioned loans after 1 April 2021 will be deemed to be incurred in the production of income.

► Vocational institutions

Exemption for profits and gains for a period of 5 years from 1 April 2021 from any vocational education program of any Vocational Education Institution if such institution has doubled its student intake of the vocational education programs from that of the previous year.

► Funds and societies which are set up for the welfare of the members

Exemption on interest earned by a welfare society is exempted after 1 April 2021. A welfare society is described as a fund or society which is formed for the welfare of its members or their respective families and contributions are made by its members.

► Exemptions on the creation and investment in Real Estate Investment Trusts (REIT)

REIT is a trust which owns/leases income generating real estate assets. REITs are popularly used in foreign countries to own many types of commercial real estate, ranging from office and apartment buildings to warehouses, hospitals, shopping centers and hotels.

Exemption on the creation of a REIT

The capital gain on the transfer of a property to a REIT is exempted from tax.

Exemption for an investment in REIT

Distributions made by a RIET is exempted from tax. Further, the capital gain on the sale of units by a REIT holder is exempted from tax.

We highlight below noteworthy amendments in relation to personal income tax

▶ Deduction for investment in solar panels

The total expenditure incurred on acquiring solar panels to affix on an individual's premises can be deducted in computing the personal taxes. Whilst the per year deduction is restricted to Rs. 600,000 per year, the total amount expenditure can be deducted over the years. If the solar panels are obtained by way of a loan, the amount paid to the bank for such acquisition can be deducted.

▶ Deduction for helping an individual to put up shop

A contribution made after 1 April 2021 in money or otherwise to establish a shop for a female individual who is from a Samurdhi beneficiary family as recommended by the Department of Samurdhi Development.

▶ Special deposit accounts and foreign currency accounts

Exemption for interest earned from these specific types of accounts.

▶ Deductions for the following expenses up to a maximum aggregate sum of Rs. 1.2 mn

- Health expenditure including contributions to medical insurance
- Vocational education or other educational expenditure incurred locally by such individual or on behalf of such individuals' children
- Interest paid on housing loans
- Contributions made to any local pension scheme, other than for a scheme under the employer or on behalf of the employer, by an employee
- Expenditure incurred to purchase shares or other financial instrument which is listed in the Stock Exchange, or treasury bills or bonds

Are you meeting your tax obligations as an employer?

We highlight below notable amendments which are likely to interest an employer

- **Payments made to non-resident employees**

  It is mandatory to deduct APIT on payments made to non-residents and non-citizen employees

- **Payments made to local employees**

  It is also mandatory to deduct APIT on payments made to local employees who has consented to deducting APIT.

- **Medical benefits**

  An employee will not be taxed on a discharge or reimbursement of a person's dental, medical or health insurance expenses where the benefit is available to all full time employees in the same grade of the service, on equal terms.

Making a payment? What next?

We highlight below notable amendments in relation to withholding tax on specific types of payments.

Payments to non-residents

It is mandatory to deduct withholding tax on the following payments with a source in Sri Lanka made to non-residents;

- Dividend - exempt
- Interest or discount - 5%/exempt
- Natural resource payment - 14%
- Rent - 14%
- Royalty - 14%
- Premium - 14%
- Service fee - 14%
- Annual insurance premium - 14%
- Payments for telecommunication - 2%
- Payments for land, sea or air transport-2%

The above is subject to concessions that may be available under a Double Tax Agreement.

Payments to residents

It is not mandatory to deduct withholding tax from payments made to residents.

However, it is possible for a resident taxpayer to make a request to withhold "Advance Income Tax" from any of the following payments that's due to him;

- Dividend
- Interest or discount
- Natural resource payment
- Rent
- Royalty
- Premium
- Periodic payments

If such a request it received tax must be withheld from the payment as specified by the CGIR.

Separate accounts

It is mandatory from 1 April 2021 to maintain and prepare financial statements to separately identify the taxable income from gains and profits which are taxed at different rates and exemptions.

Identifying a non-resident

Having a system in place to identify a non-resident service provider is important as persons present in Sri Lanka (eg-branch offices and certain individual services providers present in Sri Lanka) could be non-residents for tax purposes.

Obtaining APIT consent from local employees

A process must be put in place to obtain the employee's preference on the matter of deducting APIT from the employee's salary.

Building a better working world

Quick guide to tax rates

7 May 2021

Intended as a general guide only. Conditions may apply and rates are subject to any specific exemption that maybe available.
*Concessionary rates not applying in common for both years of assessment

Tax rates for companies – Years of assessment 2020/21 and 2021/22	Rate
Standard tax rate prior to 1 January 2020	28%
Standard tax rate 1 January 2020 onwards	24%
Small and Medium Enterprise (excluding betting and gaming and liquor)	14%
Sale of goods including exports for foreign currency	14%
Entrepot trade	14%
Offshore business without bringing goods to Sri Lanka	14%
Front end services to clients abroad	14%
Headquarter operations of leading buyers for management of financial supply chain	14%
Logistic services such as bonded warehousing	14%
Transshipment operations	14%
Freight forwarding	14%
Supply of services to an exporter of goods or services or to foreign principle for payment in foreign currency - including agent of a ship operator	14%
Manufacture and supply to an exporter of non-traditional goods	14%
Bunkering services	14%
Sale of goods manufactured in Sri Lanka by a BOI company as import replacement	14%*
Sale of health protective equipment by a BOI company to specified government bodies	14%
Ship repair/refurbishment of marine cargo containers for payment in foreign currency	14%
Provision of computer software, programs or systems or recording computer data for payment in foreign currency	14%
Sale of gem or jewelry in foreign currency made in Sri Lanka	14%
Gem and jewelry	14%
Educational services	14%
Promotion of tourism	14%
Construction Services	14%
Agro Processing	14%
Health care services	14%
Supply of electricity using renewable energy	14%*
Manufacturing	18%
Betting and gaming	40%
Manufacture and sale or import and sale of any liquor or tobacco product	40%

Reduction of tax payable – Year of assessment 2021/22
A company which lists between 1 January 2020 and 31 December 2021
Agro processing using self farmed agro produce as specified

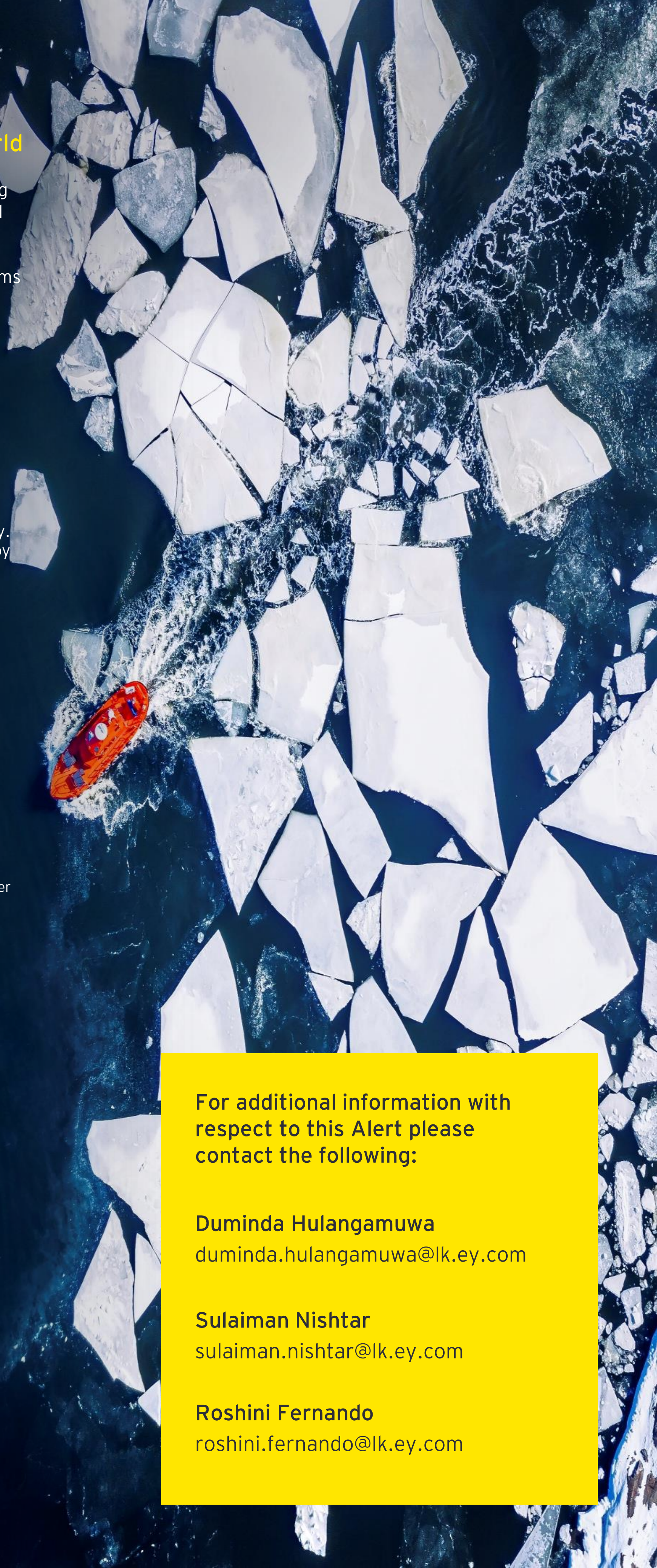
Tax rates for other bodies – Years of assessment 2020/21 and 2021/22	Rate
Partnerships - on income exceeding Rs. 1,000,000	6 %
Charitable institutions	14%
Employee Trust Funds, provident, pension or gratuity funds and termination funds	14%
Trusts	18%
Unit trusts or mutual funds that does not conduct an eligible investment business	24%
Non-governmental organizations	24%

Tax rates for resident & non resident individuals– Years of assessment 2020/21 and 2021/22	Rate
First Rs. 3,000,000	6 %
Next Rs. 3,000,000	12%
Balance	18%
Consideration for gem and jewelry	Max 14%
Supply of electricity to the national grid using renewable energy sources	Max 14%
Tax rates on aggregated terminal benefits	**Rate**
First Rs. 10,000,000	0 %
Next Rs. 10,000,000	6%
Balance	12%

Intended as a general guide only. Conditions may apply.

Dividends	Rate
Dividend received from a resident company	14%
Dividend paid by a resident company to a member to the extent that such dividend payment is attributable to, or derived from, gains and profits from dividend received by that resident company	Exempt
Dividend paid by a resident company to a non-resident person	Exempt
Dividend paid by a resident company which is engaged in hub services under the Finance Act, No. 12 of 2012 and which has entered into an agreement with the Board of Investment of Sri Lanka	Exempt
Dividend from a non-resident company derived by any person with respect to substantial participation	Exempt
Dividend falling within category of foreign soured income earned or derived in foreign currency and remitted to Sri Lanka through a bank	Exempt
Dividend from a Real Estate Investment Trust (REIT)	Exempt
Dividends received from a multinational company which increases imports as specified	Reduction of rate

Interest exempted	Rate
Interest or discount on any sovereign bond denominated in local or foreign currency, which is earned by a non-resident person (includes a realization gain)	Exempt
Interest or discount on any sovereign bond denominated in foreign currency including Sri Lanka development bonds earned by any person	Exempt
Interest accrued or derived by any person outside Sri Lanka on any loan granted to a person in Sri Lanka or to the Government of Sri Lanka	Exempt
Any person on moneys lying to his credit in foreign currency in any foreign currency account opened by him or on his behalf, in any commercial bank or in any specialized bank, with the approval of the Central Bank of Sri Lanka, on or after 1 January 2020	Exempt
"Special Deposit Account" opened by any person and maintained with an authorized dealer in Sri Lanka as prescribed in any designated foreign currency or in Sri Lanka Rupees on or after 8 April 2020	Exempt
Interest accrued or derived by a charitable institution where such interest is solely applied for charitable purpose as prescribed.	Exempt
Interest accrued or derived by any welfare society on or after 1 April 2020	Exempt
Any deposit opened and maintained in foreign currency by a multi-national company in any local bank, if such deposit is maintained to cover its import expenditure on or after 1 April 2021	Exempt
Interest or discount accrued or derived on or after 1 April 2021 by any Samurdhi community-based banks.	Exempt



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APAC no. SL00001483

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