KPMG

Salient Features of Proposed Inland Revenue Act

Contents

Imposition of Income Tax

Imposition under the current law

Income tax is imposed on profits and income on every person for that year of assessment

a) wherever arising in the case of a person who is resident in Sri Lanka, and
b) arising in or derived from Sri Lanka in the case of every other person.

Proposed imposition of Income Tax

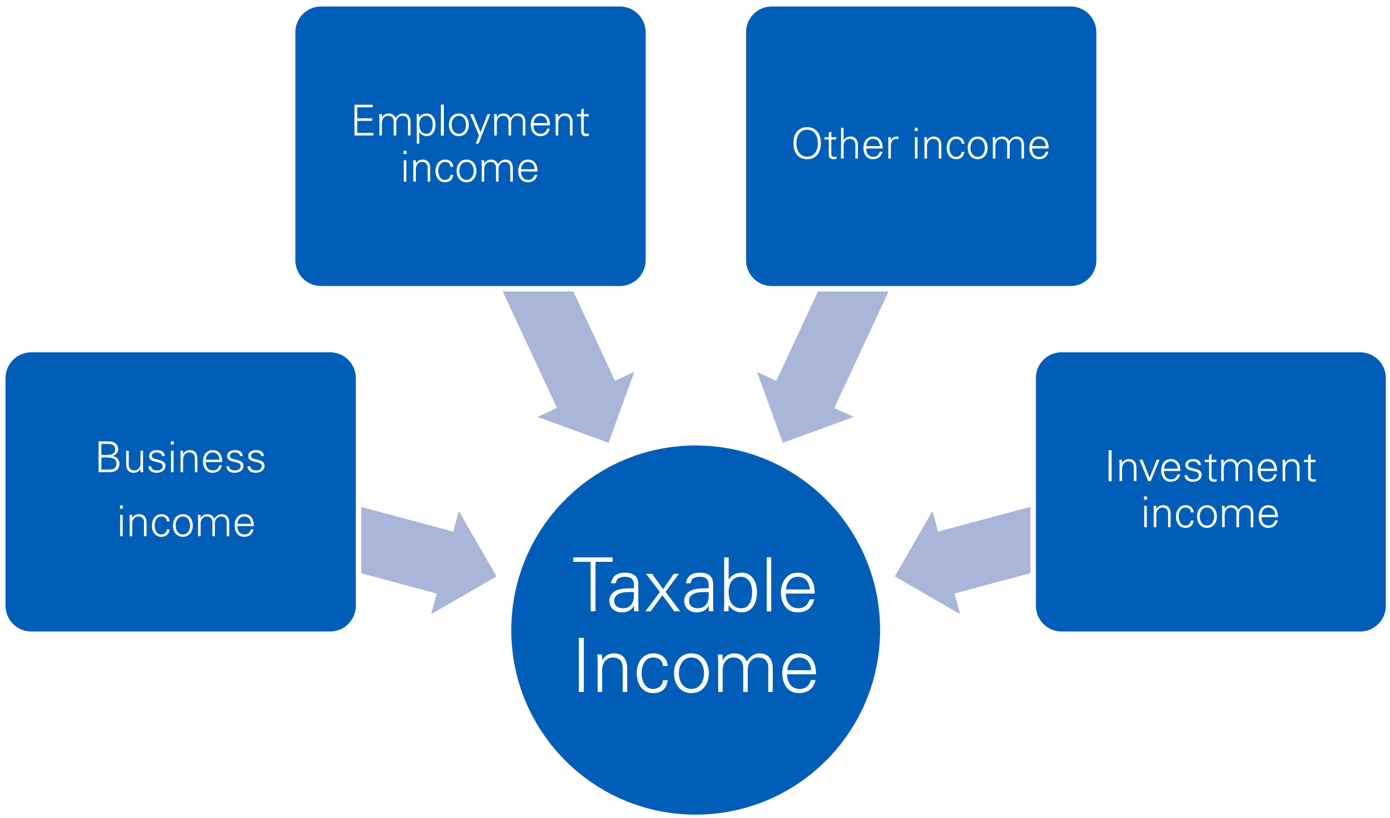
Imposition under the proposed law

- Income tax shall be payable for each year of assessment by
  a) a person who has taxable income, or
  b) a person who receives final withholding payment.

- Amount of income tax payable by a person is the aggregation of (a) and (b).

- Tax payable under (a) is calculated by applying the rates in the First Schedule and deducting tax credits including foreign tax credits.

Proposed imposition of Income Tax



Income from business

- "Business" has been defined to include:

  a) a trade, profession, vocation or isolated arrangement with a business character however short the duration of the arrangement; and

  b) a past, present or prospective business.

- "Income from business" is defined to be a person's gains and profits from conducting business for the year.

Income from business

- The law specifies that gains and profits from business should include the following:
  a) Service fees;
  b) Consideration received in respect of trading stock;
  c) Gains from the realization of capital assets and liabilities of a business;
  d) Gains on realization of depreciable assets of a business;
  e) Amounts derived as consideration for accepting a restriction on the capacity to conduct a business;
  f) Gifts received by a person in respect of the business;
  g) Amounts derived that are *effectively connected* with a business and that would otherwise be included in calculating a person's income from an investment; and
  h) Other amounts to be included under the Act.

Income from business

- The following have been excluded:
  a) Exempt amounts
  b) Final withholding payments.

Income from business

Adjustments to profits

- In calculating income from business, the following are deductible:
  a) Expenses to the extent they are incurred during the year, and
  b) Incurred in the production of income.

Income from business

Specifically permitted deductions

- Interest cost incurred in relation to a loan obtained for purchase of an asset
- Cost of sales
- Repairs and improvements limited to 5% of the written down value for buildings and 20% for all other assets
- Research and development and agricultural startup expenses
- Depreciation allowances and balancing allowances
- Losses from realization of business assets and liabilities
- Financial cost of a manufacturing entity up to 3 times of share capital and reserves, and any other entity up to 4 times (other than a bank)

Income from business

Depreciation allowances

Asset category	Proposed Act	Current law
1. Computers and data handling equipment together with peripheral devices.	20%	25%
2. Buses and minibuses, goods vehicles; construction and earth-moving equipment, heavy general purpose or specialised trucks, trailers and trailer-mounted containers; plant and machinery used in manufacturing	20%	20% / 33 1/3%
3. 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	20%	20% / 33 1/3%
4. Buildings, structures and similar works of a permanent nature	5%	10%
5. Intangible assets, excluding goodwill	The actual useful life of the intangible asset, or where the intangible asset has an indefinite useful life.	10%

Income from business

Deductions withdrawn in the proposed Act

- Accelerated depreciation provided for certain categories of assets.
- Deduction up to 200% and 300% on research and development expenses.
- 300% deduction on expenditure incurred by any person registered with the Tertiary and Vocational Educational Commission on standard skill development training by any institution recommended by such Commission.
- 300% deduction on expenditure incurred for brand promotion for the export of products manufactured.
- Annual payments to a Gratuity Fund approved by the Commissioner General of Inland Revenue.
- Rentals paid under finance lease agreements

Income from business

Specific disallowances in the proposed Act

- Domestic or private expenses.
- Entertainment expenses.
- Income tax and any other prescribed levy.
- Sums transferred to any reserve or provision.
- Depreciation allowance, rentals or annual payments for motor vehicles used for travelling other than motor cycles used by non executive officers or motor coach used for transporting employees.
- Depreciation allowance, rentals or annual payments on assets used at an employee's residence.
- Any expenses incurred not in relation to the production of income.
- Payments to pension or provident funds not approved by the Commissioner General of Inland Revenue.

Income from business

Specific disallowances in the proposed Act

- Bribes and expenses incurred for corrupt practices.
- Interest, penalties and fines payable to a government or a political sub division of a government of any country for breach of any law or subsidiary legislation.
- Expenditure incurred to derive exempt income or final withholding tax payments.
- Amounts incurred on lotteries, betting or gambling.
- A payment on which tax should have been withheld by a payer and where such tax has not been paid to the Commissioner General of Inland Revenue.
- Capital expenditure.
- Expenses other than those expressly permitted by the Act.

Income from business

Disallowances withdrawn in the proposed Act

- Foreign travelling expenses.
- Expenses connected with providing accommodation to employees, any assets to be used in the residence of such employees or any property given to employees below the market value of such assets.
- Management fees exceeding LKR 2MN or 1% of turnover, whichever is lower.
- 25% of cost of advertising.
- Expenditure or outgoings in relation to any loans or advances granted to employees which are subsequently written off.
- Lease interest under finance lease agreements
- Fixed rentals or annual payments in respect of any vehicle used for travelling and any plant, machinery, fixtures, equipment or articles for use in the residence of an employee.

Industry-specific provisions

Banking	• Financial instruments to retain the timing and character as per financial statements. • The provisioning to be subject to criteria set by the Commissioner General of Inland Revenue
Life assurance	• The deduction of management expenses limited to management of fund.
Leasing	• Leasing is to be considered akin to lending. • Capital allowance claims not permissible.
Unit Trusts	• Unit trust engaged in trading in capital assets and financial instruments will not be deemed to be a company.

Concessions

Qualifying criteria	Rate
• Business should be carried on in any part in Sri Lanka, **other than in the Northern Province.** • Total cost incurred on depreciable assets (other than on intangible assets) during a year of assessment, should be between USD 3Mn – USD 5 Mn ; and • Employment cadre increased by at least 250 new employees who are subject to tax under the PAYE tax scheme during a year of assessment.	100%
• Business should be carried on in any part in Sri Lanka, **other than in the Northern Province** • Total cost incurred on depreciable assets (other than on intangible assets) during a year of assessment should be between USD 5Mn – USD 50 Mn, and • Employment cadre increased by at least 350 new employees who are subject to tax under the PAYE tax scheme during a year of assessment.	100%
• Total cost incurred on depreciable assets (other than on intangible assets) in Sri Lanka during a year of assessment should exceed USD 50Mn.	100%

Concessions

Qualifying criteria	Rate
• Total cost incurred on depreciable assets (other than on intangible assets) during a year of assessment should exceed USD 100Mn	150%
• Total cost incurred on depreciable assets (other than on intangible assets) during a year of assessment should exceed USD 2,000Mn • Depreciable assets should have been acquired in relation to development of a port or an airport in Sri Lanka.	100%
• Business should be carried on **in the Northern Province;** • Total cost incurred on depreciable assets (other than on intangible assets) during a year of assessment should be between USD 3Mn – USD 5 Mn ; and • Employment cadre increased by at least 250 new employees who are subject to tax under the PAYE tax scheme during a year of assessment.	200%

Concessions

Qualifying criteria	Rate
• Business should be carried on **in the Northern Province** • Total cost incurred on depreciable assets (other than on intangible assets) during the year of assessment should be between USD 5Mn – USD 50 Mn and • Employment cadre increased by at least 350 new employees who are subject to tax under the PAYE tax scheme during the year of assessment	200%
Temporary concession for first 3 years of enactment • Total cost incurred on the following depreciable assets (other than intangible assets) during the year of assessment up to USD 3Mn: - Buildings, structures and similar works of a permanent nature - Plant or machinery used to improve business processes or productivity and fixed to the business premises.	
• Where such assets are used in any part in Sri Lanka, **other than in the Northern Province.**	100%
• Where such assets are used **in the Northern Province.**	200%

Tax avoidance provisions

- Section 28 – Permits the CGIR to redefine the recipient and payer.

- Section 33 – Arms' length principle to apply to associated persons. CGIR empowered to recharacterize any arrangement, source of income, apportionment and allocation of expenses.

- Section 34 – CGIR to prevent income splitting.

- Section 35 – CGIR has the discretion to disregard any scheme where the sole or dominant purpose is to obtain a tax benefit.

Amendments to Transfer Pricing provisions

- Associated Undertaking is presently prescribed by Gazzette. The scope of same is to be expanded to cover:

  - Associated enterprise where one person participates directly or indirectly or through one or more intermediaries in the management, control or capital of the other.
  - Are deemed to be associated enterprises to the extent they are prescribed.
  - A permanent establishment.

- Technical Review Committee and Dispute Resolution Panel to review audit findings prior to issue of assessments.

- No tax benefit for Transfer Pricing adjustments.

- Safe harbor rules to be issued by CGIR.

Amendments to Transfer Pricing provisions

- The following penalty provisions are to be introduced to both international and domestic transactions:

  - Non-maintenance of documentation – 1% of aggregate value of transactions with Associated Enterprises.
  - Non-submission of required documents – sum not exceeding LKR 250,000/-.
  - Non-disclosure of information – 2% of aggregate value of transactions with Associated Enterprises.
  - Non-submission of required documents on a specified date – sum not exceeding LKR 100,000/-.
  - Concealing particulars of income, or furnishing inaccurate particulars of such income; and seeking to evade tax through same – 200% of the value of additional tax.

Thank you