Proposed Inland Revenue Act

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For clients of KPMG in Sri Lanka

The Bill to incorporate a new Inland Revenue Act has been gazetted and made available today in the website of the Department of Government Printing at http://documents.gov.lk/en/bills.php

The new Bill seeks to replace the existing income tax law with a view to simplify and modernize the income tax legislative framework.

We attach hereto a synopsis highlighting the key features of this law, together with an analysis against some of the provisions of the prevailing Income Tax law.

It is our understanding that the law will be operational prospectively on being enacted by Parliament.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

Chartered Accountants

Contents

Summary of key changes

- The sources of income have been condensed and re-classified under 4 heads - employment, business, investment and other.
- Tax on capital gains arising on investment assets has been reintroduced at 10%.
- Employment income to be taxed under progressive rates up to 24% and slabs applicable for taxable income of an individual have been revised.
- Qualifying payment relief on employment income of resident individuals has been increased from LKR 250,000/- to LKR 700,000/-.
- Capital allowance rates have been revised. Enhanced depreciation has been afforded to specified investments.
- Rules on utilization of losses have been revised. Unutilised losses can be carried forward only up to 6 years.
- Definition of "dividend" has been revised to include share repurchase and capital reduction.
- Withholding tax scope has been expanded and tax rates have been revised. Accordingly, service payments would be liable to withholding tax.
- The rate of tax applicable to dividends and interest has been increased from 10% to 14%.
- Resident companies are not entitled to claim credit on taxes withheld on interest income. Interest net of withholding tax to be subject to tax. Resident financial institutions are not subject to withholding tax on interest income.
- The proposed law does not provide for notional tax credit. Interest on government securities in the secondary market would not carry tax credit.
- Definitions have been provided for the terms "royalty" and "service fees". Further, the term "management expenses" in relation to life assurance business has been defined.
- Tax rates to be revised and a three tier tax structure has been introduced. Deemed dividend tax has been withdrawn.
- "Permanent establishment" concept has been introduced to ascertain the business income of a non-resident.
- Exemptions have been streamlined and most of the institutional exemptions have been withdrawn.
- Time bar provision for raising assessments has been extended to 4 years, other than in the case of default assessments. The time for determining an appeal, by the Commissioner General of Inland Revenue, has been reduced to 3 months.
- Provisions for advanced ruling system have been strengthened.
- Department of Inland Revenue has been given enhanced powers to relook at transactions, specially those between associated persons.

Basis of liability

A resident person is liable to income tax during a year of assessment on his **global income** from employment, business, investment or from any other source.

A non-resident is liable to tax on income from employment, business, investment and other sources, **arising in or derived from a source in Sri Lanka.**

Determination of residency

Individual

An individual is considered as a resident for a year of assessment, if such individual:

a) resides in Sri Lanka, or

b) is domiciled in Sri Lanka, unless the individual has a permanent home abroad and does not have a permanent home in Sri Lanka, or

c) is present in Sri Lanka for a period of 183 days or more, in any 12 month period which commences or ends during that year of assessment

Company

A company is considered as a resident for a year of assessment if:

a) it is incorporated or formed under the laws of Sri Lanka, or

b) its registered or principal office is in Sri Lanka, or

c) management and control of the affairs of the company are exercised in Sri Lanka at any time during a year of assessment.

Income liable to tax

Presently, the law prescribes eight sources of income liable to tax and same has been condensed to four in the proposed Act. However, it appears that all sources of income which are currently liable to tax, continue to be liable to tax and coverage has been expanded to cover capital gains.

Prevailing	Proposed
Employment income	Employment income
Business income	Business income
Dividends, interest and discounts Charges and annuities Rents, royalties and premium Winnings from lotteries, betting and gaming	Investment income including capital gains
Income from any other source	Income from any other source

We would note that previously sums received by a Non-Governmental Organization as grants, donations or contributions etc. were considered income liable to tax. Whilst the intention seems to be to continue to tax the same, it has been omitted from coverage. Hence, same would have to be incorporated into this section.

Process of determining tax liability

Income from sources (Slides 8-12)

↓ *Less*

Exempt income (Slides 13-14)
Final withholding payments (Slide 15)

↓ *Less*

Tax losses (Slide 16)
Qualifying payments and other deductions (Slide 17)

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Taxable income

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Tax liability (Slide 18)

Employment income

Employment income is to be taxed on a cash basis, i.e. on receipt.

The following benefits are taxable as income from employment:

- Salary, wages, leave pay, overtime pay, fees, pensions, commissions, gratuities, bonuses, and other similar payments;
- Personal allowance, including any cost of living, subsistence, rent, entertainment or travel allowance;
- Payments providing discharge or reimbursement of expenses incurred by an individual or an associate of the individual;
- Payments for an individual's agreement to conditions of employment;
- Payments or transfers to another person for the benefit of an individual or an associate person of the individual;
- The fair market value of benefits received or derived by virtue of the employment by an individual or an associate person of the individual;
- Other payments, including gifts, received in respect of the employment;
- 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, excluding the employer’s contribution for such shares;
- Payments for redundancy or loss or termination of employment;
- Retirement contributions made to a retirement fund on behalf of the employee and retirement payments received in respect of the employment, other than contributions made by the employer to a pension fund, provident or savings fund/society, approved by the Minister;

The following benefits are excluded:

- Benefits identified as exempt and benefits subject to final withholding tax;
- 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;
- 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 such shares are granted to an employee under an employee share scheme.

Business income

Business income is to be accounted for, on an accrual basis, unless approval has been obtained from the Commissioner General of Inland Revenue to adopt a cash basis.

For this purpose, “business income” includes gains and profits from conducting a business consisting of:

- service fees;
- consideration received in respect of trading stock;
- gains from the realization of capital assets and liabilities of a business;
- gains on realization of depreciable assets of a business;
- amounts derived as consideration for accepting a restriction on the capacity to conduct a business;
- gifts received by a person in respect of the business;
- 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
- other amounts to be included under the Act.

However, business income does not include exempt amounts and final withholding payments.

Adjustment to profits

The proposed law permits deduction of expenses which have been incurred for the production of income during a year of assessment, when ascertaining profits from business. Such expenses can be claimed subject to restrictions and conditions stipulated in the law.

Unless specifically mentioned, profits from business or investment, liable to Income Tax, should be ascertained according to generally accepted accounting principles.

An analysis of the status of the prevailing permitted deductions under Section 25 of the Inland Revenue Act No. 10 of 2006 (as amended), as well as new provisions introduced under the proposed law, have been provided at Annexure I.

The status of the prevailing disallowances specified under Section 26 of the Inland Revenue Act No. 10 of 2006 (as amended), as well as new provisions introduced under the new law, have been provided at Annexure II.

Investment income

Investment income must be accounted for by an individual on a cash basis, unless approval has been obtained from the Commissioner General of Inland Revenue to adopt accrual accounting. An entity could select the most appropriate method (i.e. cash or accrual basis) to account for investment income.

The term “investment income” includes gains and profits from investment consisting of:

- dividends, interest, discounts, charges, annuities, natural resource payments, rents, premiums and royalties;
- gains from the realization of investment assets;
- amounts derived as consideration for accepting a restriction on the capacity to conduct the investment;
- gifts received by a person in respect of an investment;
- winnings from lotteries, betting or gambling; and
- other amounts required to be included under the Act.

However, the term “investment income” does not include:

- profits identified as exempt;
- profits which have been subject to final withholding tax; and
- amounts included under business income.

The term “investment asset” has been defined to mean the following assets held as part of an investment excluding trading stock or a depreciable asset:

a) land or buildings

b) a membership interest in a company, partnership or trust

c) a security, or other financial asset

d) an option, right or other interest in an asset referred to in the foregoing paragraphs;

Further, the scope of an investment asset excludes the principal place of residence of an individual provided;

- such property has been owned by such person for 3 consecutive years prior to disposal, and
- the individual lived in such premises for at least 2 years out of those 3 years.

Investment income

Capital gains – Basis of chargeability

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

The draft law provides for the ascertainment of a deemed gain in circumstances, other than on death, where a transfer has taken place for no consideration.

Capital gains - Tax rate

10% on the gain on realization of an investment asset.

Capital gains - Payment of tax and return filing

A tax due on a capital gain has to be settled within one month of the realization of the asset. The tax payer is also required to file a tax return within the same time period.

Other income

A person could select the most appropriate method (i.e. cash or accrual basis) to account for other income.

Other income consists of gains and profits from any other source, excluding profits of a casual and non-recurring nature.

However, other income does not include income which is identified as exempt or profits subject to final withholding tax.

Exemptions

The proposed Act seeks to reduce the exemptions provided under the current statute and such exemptions have been limited to the following;

Realization of investments

- Gain made by a resident individual from realization of an investment asset not exceeding LKR 50,000 per transaction and LKR 600,000 per year of assessment.
- Gain made by a resident individual from realization of the principal place of residence provided that such place is owned by such individual for three consecutive years immediately prior to the disposal and lived in such property for at least two years out of those three years.
- Gain from realization of shares listed in the Colombo Stock Exchange, which were held as investment assets.

Interest income

- Interest accruing to a non- resident or any licensed commercial bank in Sri Lanka, on any sovereign bond denominated in foreign currency, issued by or on behalf of the Sri Lankan Government.
- Interest accruing to a charitable institution, which is utilized for prescribed purposes.

Employment income

- Compensation or gratuity paid in lieu of personal injuries or death.
- Amounts paid on retirement from any Provident, Pension, or the Employees' Trust Fund, representing investment income earned for any period commencing on or after 01 April 1987.
- Pension received from the Sri Lankan Government or from a Department of the Government.
- Employment income of the President.
- Benefits derived by a government employee, from a road vehicle permit granted to such employee.
- Income derived by an individual entitled to privileges under the Diplomatic Immunities Law and other specified conventions.

Dividend income

- Dividend paid by a resident company out of dividend received that was subject to withholding tax.

Exemptions

Other exemptions

- Amounts derived by government institutions, foreign governments and international organizations as specified.
- Prize received from the President or the government for an invention created or research undertaken.
- Sums received from the President’s Fund or National Defense Fund.
- Winnings from lottery not exceeding LKR 500,000/-.
- Amounts accruing to a senior citizen from an annuity for life for a period not less than 10 years, purchased from a bank or an insurance company.

Final withholding payments

Taxes withheld for the following payments will be considered to be final withholding taxes and hence, such payments will not form part of taxable income.

- Dividends paid by a resident company to a resident person;
- Interest paid to, or treated as being derived by, a resident individual (other than such amount of interest paid to a senior citizen as specified in regulations);
- Amounts paid as winnings from a lottery, reward, betting or gambling, other than amounts received in conducting a business consisting of betting and gaming; and
- Payments made to non-resident persons that are subject to withholding tax, other than payments derived through a Sri Lankan permanent establishment.

Employment income has not been included as income being subject to final withholding tax. It is very likely that same will be included under this category.

Utilization of losses

The current provisions in relation to utilization of losses have been revised, and two categories of losses have been identified namely;

– Business losses, and

– Investment losses

Losses incurred from business during a year of assessment could be set off against income from business activities or against income from investment activities. However, losses incurred on the realization of investments could only be set off against income from investments.

Any unutilized losses could be carried forward and set off in the same manner over a period of 6 years. If the loss has been incurred due to enhanced depreciation allowance claimed during a year of assessment, the carry forward period for set off has been extended to ten years or twenty five years.

If the loss has been incurred in a business activity which is subject to tax at a reduced rate, such loss could be utilized only in calculating income which is taxed at the same rate, lower rate or exempt profits.

Losses incurred in an exempt activity can be set-off only against a profit which is exempt from tax.

The current restriction on the annual utilization of losses which is limited to 35% of total statutory income, has been withdrawn.

Presently, losses arising from carrying out a business of leasing and life assurance can only be set-off against profits from the same business. This limitation is being withdrawn.

Other deductions

- ***Qualifying payments***

  Deductions have been granted by way of qualifying payments in arriving at taxable income of an individual or an entity.

  Qualifying payment relief available under the current law has been reduced and restricted to donations made to prescribed institutions.

  Deductibility of donations to an approved charity has been limited to ;

  – One third of taxable income, or LKR 75,000/-, whichever is less in the case of an individual.

  – One fifth of taxable income, or LKR 500,000/-, whichever is less, in the case of an entity.

  Deductibility of donations to any other prescribed institution could be claimed up to the limit of taxable income of that year of assessment and no provisions available to carry forward any excess payments over the taxable income, to subsequent years of assessment. A list of other prescribed institutions is provided in Annexure III.

- ***Prescribed deductions***

Resident individuals	• LKR 500,000/- per year of assessment to any individual. This will not apply to income received by an individual in the capacity of a trustee, receiver, executor or liquidator and on gains from realization of investment assets. • LKR 700,000/- per year of assessment against employment income of an individual. • Upto LKR 1,500,000/- against interest income of a Senior Citizen. • An amount equal to 25% of rental income received by an individual from an investment asset. This has been granted for repair, maintenance and depreciation, in relation to the investment asset, provided actual expenses have not been claimed when ascertaining profits liable to tax.
Citizen non resident individuals	• LKR 500,000/- per year of assessment This will not apply to income received by an individual in the capacity of a trustee, receiver, executor or liquidator.

The qualifying payment relief of LKR 250,000 granted to a non-resident non-citizen employee has been withdrawn.

Tax rates

- ***Individuals***

The current tax slabs applicable for an individual have been revised as follows:

Taxable income (LKR)	Tax rate
First 600,000	4%
600,000-1,200,000	8%
1,200,000-1,800,000	12%
1,800,000-2,400,000	16%
2,400,000-3,000,000	20%
Exceeding 3,000,000	24%

The maximum tax rate of 16% applicable on employment income has been withdrawn.

Gains on realization of investment assets will be taxed at 10%.

Income from the business of betting and gaming, liquor and/or tobacco will be taxed at 40%.

The prevailing reduced rates of tax on retirement benefits (gratuity, ETF etc.) will continue.

- ***Companies***

The proposed law seeks to revise the prevailing income tax rate structure and has introduced a three-tier structure as follows:

Sector	Tax rate
SME, exporters*, agricultural business*, educational services*, promotion of tourism* and information technology services*	14%
Other sectors	28%
Betting and gaming, liquor and/or tobacco	40%

* *The revised tax rate is applicable to a company solely engaged in the stated business activity. For this purpose, the terms "agricultural business", "promotion of tourism" and "information technology" have been defined.*

Gains on realization of investment assets will be taxed at 10%. Deemed dividend tax has been withdrawn.

A synopsis of revised tax rates applicable to companies and other entities have been provided at Annexure IV.

Withholding tax

Scope

The scope has been expanded to cover the following payments which are currently not subject to withholding tax:

- Specified service fees paid to a resident individual (not being an employee of the payer), including payment in relation to a supply of any article on a contract basis through tender or quotation
- Rent paid to a resident
- Service fees paid to a non-resident
- Insurance premium paid to a non-resident
- Interest on loans (other than interest paid to resident financial institutions)

The prevailing withholding tax rate of 5% on management fees paid to a resident, has been withdrawn.

Interest

A resident company will be liable to tax on the net interest income received, after deduction of withholding tax (as a cost). No tax credit will be available for the withholding tax paid on such interest.

Withholding tax rates

The withholding tax rates applicable for various payments have been revised. A comparison of the new withholding tax rates with the prevailing rates, is provided at Annexure V.

Concessions

Enhanced depreciation allowances

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%
• 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

Enhanced depreciation allowances

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.** • Where such assets are used **in the Northern Province.**	 100% 200%

Investment Tax Credit

- A tax credit is available against the tax payable by a person, where such person has claimed an enhanced depreciation allowance as stated above and incurred expenses exceeding USD 5Mn on depreciable assets (other than on intangible assets) during the previous year of assessment.

- The tax credit is limited to lower of the Income Tax payable for that year of assessment or 5% of total investment made during the previous year of assessment in depreciable assets (other than on intangible assets)

Withholding tax exemption on dividends paid to a non-resident

- In the event a company has incurred expenses exceeding USD 2,000 Mn on depreciable assets (other than on intangible assets) in Sri Lanka, and pays dividend to a non-resident shareholder out of profits ascertained after adjusting for enhanced depreciation, such dividends would be exempt from withholding tax.

Concessions

Exemption on employment income of expatriate employees

- In the event a company has incurred expenses exceeding USD 2,000 Mn on depreciable assets (other than on intangible assets) in Sri Lanka, employment income of expatriate employees (upto a maximum of twenty employees) who are working in such undertaking would be exempt from income tax in Sri Lanka during the year in which the enhanced depreciation allowance is claimed.

Industry-specific provisions

Banking

Income or loss from the business of banking should be computed separately from other business activities. For this purpose, the term "banking business" means "the banking business of a financial institution".

The prevailing restriction on the claim of doubtful debts (ie. up to a maximum of 1% on aggregate debts outstanding at the end of a year of assessment) has been withdrawn. Furthermore, debts written off and doubtful debts could be claimed as long as the person has taken reasonable steps in pursuing payment and the person reasonably believes that such debt will not be recovered.

In the event a bank opts to claim doubtful debts based on provisions made in line with regulations established by the Central Bank of Sri Lanka, the amount deductible would be limited to the extent specified by the Commissioner General of Inland Revenue.

Life Assurance

The term "profits from the business of Life Assurance" has been defined as investment income of the Life Insurance Fund less "management expenses". For this purpose, the new law defines the term "management expenses" to include the following expenses exclusively incurred for the administration of the Life Insurance Fund:

a) Salaries and other related expenses incurred for the employees, who were assigned for managing the investment portfolio;

b) Capital allowances in respect of depreciable assets exclusively owned and used by the Fund;

c) Other expenses reasonably attributable to the administration of the Life Insurance Fund such as directors' salaries, rent and other common expenses, excluding commission and similar expenses paid to insurance agents and advertisement expenses.

Current restriction on utilization of losses from Life Assurance business against profits from other sources has been withdrawn.

Finance Leasing

Finance lease agreements to be considered as a loan granted by the lessor to the lessee. Accordingly, the current method of calculating the profits from the business of finance lease may change and the leasing business would be subject to tax on profits derived from such operations being the lease interest less expenses. Entitlement to depreciation allowance on road vehicles has been amended and this may affect the industry.

Current restriction on utilization of losses from lease business against profits from other sources has been withdrawn.

Other provisions

Definition of “dividends”

The definition of the term “dividends” has been revised to include;

- Payments received by shareholders in the course of repurchase of shares, reduction of capital or liquidation process or reconstruction,
- Capitalization of profits by way of bonus issue or increase in paid up capital or otherwise whether an amount is distributed or not.

The following will not be considered as distribution of a “dividend”:

- Any amount debited to a capital account or matched by a payment made by a shareholder to a company.
- Any amount which constitutes a final withholding payment or included in calculating the income of a shareholder.

Definitions of “royalty” and “service fees”

The prevailing statute does not contain definitions for the terms “royalty” and “service fees”. The same have been defined in the proposed Act as follows:

- ***Royalty***

  A payment derived as a consideration for –

  a) 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; or

  b) the use of or right to use a patent, trade mark, design or model, plan, or secret formula or process; any industrial, commercial, or scientific equipment; information concerning industrial, commercial, or scientific experience;

  c) the rendering of or the undertaking to render assistance ancillary to a matter referred to in paragraph (a) or (b) above; or

  d) a total or partial forbearance with respect to a matter referred to in paragraph (a), (b) or (c) above.

- ***Service fees***

  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

Other provisions

Foreign tax credit

A resident person (other than a partnership) could claim a tax credit for any tax paid in a foreign jurisdiction in relation to any of his assessable foreign income earned during a year of assessment. Foreign tax credit should be calculated separately for each year of assessment and separately for each source and further, separately for each gain from the realization of investment asset.

Permanent Establishment

The new law has introduced the concept of "Permanent Establishment".

Any payment made to a non-resident, which is subject to withholding tax, becomes final tax to such non-resident unless same is derived through a Sri Lankan Permanent Establishment of such non-resident.

Non-Governmental Organizations

The current basis of calculating income tax liability will continue. Accordingly, 3% of funds received by way of grants, donations or contributions would be subject to tax at 28% in addition to tax on other sources of income. Currently, the law provides for exclusions on certain donations received, when calculating the tax liability on funds received. The current exclusion granted for money received from the Government of Sri Lanka, has been withdrawn.

Gains from the realization of investment assets will also be subject to tax at 10%.

Partnerships

The new law excludes a partnership from chargeability to income tax, other than withholding tax and tax on gains from realization of investment assets, and seeks to make only the partners liable to tax in respect of their share of income from the partnership.

Allocation of profits to partners will be subject to withholding of tax at 8%.

Gains from the realization of investment assets of the partnership will be taxed at 10% to the partnership. Gain on disposal of an interest of a partner in a partnership would be treated as business income of the partner and liable to tax.

Unit Trusts

The tax rate on taxable income of unit trusts has been increased from 10% to 28%. However, any gains from realization of investment assets will be subject to tax at 10%.

The exemptions available under the current law on dividends distributed by a unit trust and dividends distributed to a unit trust, have been withdrawn.

Administrative provisions

Year of Assessment

A year of assessment is a twelve month period ending 31st March. Companies and Trusts are permitted to change the year of assessment with the approval of the Commissioner General of Inland Revenue.

Payment of tax

Tax liability for a year of assessment should be settled in four quarterly installments if a person derives or expects to derive assessable income from business, investment or employment which has not been subject to tax under the PAYE Tax Scheme. The payments are required to be made based on the estimated tax liability for a year of assessment. A statement of estimated tax liability for a year of assessment should be filed with the Revenue Authorities at the time of making payment of the first installment. Once the tax liability for a year of assessment is finalized, any outstanding tax is required to be settled on or before 30th September of the succeeding year of assessment.

Tax due on gains from realization of an investment asset needs to be settled within one month after realization of such asset.

Filing of tax return

An income tax return is required to be filed on or before 30th November of the succeeding year of assessment.

A capital gains tax return needs to be filed within one month after the realization of an investment asset.

At the request of the taxpayer, the Commissioner General of Inland Revenue may grant an extended time period to file a tax return.

In the event a tax return is prepared by a third party (other than a full time employee of the tax payer), for a reward, such party should also sign the tax return.

Provisions have been introduced for a taxpayer to amend a tax return within 4 years from the date of filing such return.

Time bar for assessment

The time bar provisions for raising an assessment have been extended, and accordingly, in the event a tax payer has filed a tax return, an assessment could be raised within 4 years from the date of filing such return.

Time bar provisions will not apply in the event of non-filing of a tax return or for fraud or willful evasion of taxes.

Administrative provisions

Hearing of appeal

The tax payer should appeal for an assessment within thirty days from the receipt of such assessment. The appeal shall be determined within ninety days.

Tax Avoidance Scheme

Provisions have been introduced to prevent tax payers implementing tax avoidance schemes. A scheme is considered as being for tax avoidance if the sole or dominant purpose of same is to obtain a tax benefit.

If a tax avoidance scheme has been carried out as per the opinion of the Commissioner General of Inland Revenue, an assessment could be raised to adjust the tax liability within five years from the end of the year of assessment to which such adjustment relates.

Review of transactions between Associated Persons

Provisions have been introduced for the Commissioner General to review re-characterize/ disregard any transaction between the following associated persons, if it cannot be established that the said transactions have been concluded in line with the arm's length standard.

- An individual and his relative
- Partners of a partnership
- Person controlling an entity or benefitting from 50% of the voting power of an entity either alone or together with associated persons, either directly or through one or more interposed entities
- Persons that may reasonably be expected to act as associated persons (other than employee)

Administrative provisions

Advanced Ruling system

Provisions have been introduced to strengthen the current advanced ruling system. Accordingly, rulings will be issued under two categories as follows;

- **Binding Public Rulings**

  The Commissioner General of Inland Revenue may issue public rulings setting out the Commissioner General's interpretation of the application of tax law. A public ruling is binding on the Commissioner General until same is withdrawn. However, same is not binding on a tax payer.

- **Private Rulings**

  A tax payer could request for a private ruling seeking the view of the Commissioner General of Inland Revenue on the application of tax law with regard to a transaction. A reasonable fee may be charged for this purpose. The ruling must be issued within 90 days from the date of request. A private ruling will be binding on the Commissioner General of Inland Revenue as against the tax payer identified, but shall not be binding on the Commissioner General of Inland Revenue as against other tax payers. Furthermore, a private ruling shall not be binding on a tax payer.

Transitional provisions

Transitional provisions concerning depreciation allowances, tax exemptions etc. have not been fully covered and will have to be further clarified.

Transfer pricing

Permanent Establishment

A "Permanent Establishment" has been deemed to be independent from its head office. Currently, transactions of a permanent establishment which may operate in Sri Lanka in the form of a branch or other overseas office and have transactions with the head office, is not covered by transfer pricing provisions, since it is one legal entity.

The proposed law is to view a permanent establishment separate from its head office.

Introduction of Safe Harbour Rules

Safe Harbour Rules are to be introduced to simplify transfer pricing compliance requirements. Under safe harbor provisions, the Revenue Authorities generally prescribe comparable prices/margins so as to determine an arm's length price.

Audit Procedure

The draft law details the audit procedure that needs to be complied with prior to an assessment being issued on a taxpayer. The following additional procedures have been introduced:

- A Technical Review Committee to be formed to review the preliminary order raised by a Transfer Pricing Officer and issue an interim order or final order.
- Same to be communicated to the taxpayer by the Transfer Pricing Officer.
- A Dispute Resolution Panel to be introduced to review any dissatisfactions of a taxpayer relating to the final order.
- Assessment could be raised only after final order has been issued by the Dispute Resolution Panel.

Transfer pricing

Penalties

Any tax adjustments made on account of transfer pricing would not be entitled to tax benefits.

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.

Annexures

Annexure I - Permitted Deductions

Common provisions in both Acts	Claims withdrawn in the New Act
• Depreciation allowance The prevailing rates have been revised to 5% for buildings and improvements, and 20% for other assets. • Intangible assets To be amortized over the useful life. • Repairs and improvements Deduction is restricted to a percentage of written down value of assets at the end of the previous year. Balance can be capitalized. • Bad debts incurred and provisions for doubtful debts Deductions permitted subject to conditions. • Interest expenses. • Contribution to a pension, provident or savings fund approved by the Commissioner General of Inland Revenue. • Tax payable under any Statute enacted by a Provincial Council in relation to the business. • Research and development expenses, and agricultural start-up expenses • Royalty and ground rent • Allowance for trading stock The law prescribes the method of calculating the allowance • Expenses in relation to long term contracts The law prescribes that expenses should b claimed on percentage of completion basis • Travelling expenses incurred in connection with the business. • Any other expense incurred for the production of income unless it is specifically disallowed under the law.	• 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. • Payment of gratuity to an employee at the time of termination of employment. • Payment of gratuity on cessation of business • Rentals paid under finance lease agreements The law allows only the lease interest as a deductible expenses.

Annexure II - Specific Disallowances

Common provisions in both Acts	New disallowances introduced	Disallowances withdrawn
• Domestic or private expenses. • Entertainment expenses. • Expenses of a capital nature. • Income tax and any other prescribed levy. • Sums transferred to any reserve or provision. • Head office expenses over 10% of statutory income. • 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. • Thin capitalization rules amended to cover loans obtained from any person other than a bank or a financial institution. • Payments to pension or provident funds not approved by the Commissioner General of Inland Revenue.	• 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.	• Foreign travelling expenses (subject to conditions). • Entertainment allowance paid to an executive officer. • Cost of improvements and repair expenses exceeding 25% of gross rent receivable in relation to a business of renting premises. • 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 • Expenses incurred in listing shares in the Colombo Stock Exchange over 1% of the value of the Initial Public Offering. • 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.

Annexure III

Qualifying payments – List of prescribed institutions

The list of prescribed institutions (other than an approved charity) is given below;

- The Government of Sri Lanka.
- A local Authority.
- Any Higher Education Institution established or deemed to be established under the Universities Act, No. 16 of 1978.
- The Buddhist and Pali University or any Higher Educational Institution established by or under the Buddhist and Pali University Act, No. 74 of 1981.
- A Fund established by the Government of Sri Lanka.
- A Fund established by a local authority and approved by the Minister.
- The Sevana Fund created and administered by the National Housing Development Authority established by the National Housing Development Authority Act, No. 17 of 1979.
- A Fund established by a Provincial Council and approved by the Minister.
- The Api Wenuwen Api Fund established by the Api Wenuwen Api Fund Act, No. 6 of 2008.
- National Kidney Fund established under the National Kidney Foundation of Sri Lanka (Incorporation) Act, No. 34 of 2006.
- Profits remitted to the President's Fund established by the President's Fund Act, No. 7 of 1978 by a public corporation as required by the law by or under which such corporation is established.

Annexure IV - Revised tax rates

Sector/Institution	Proposed rate	Prevailing rate
Companies		
SME	14%	12%
Exporters *	14%	12%
Agriculture *	14%	10%/12%
Educational services *	14%	10%
Promotion of tourism *	14%	12%
Information technology services *	14%	0%/10%/28%
Construction work	28%	12%
Healthcare services	28%	12%
Supply of labour	28%	10%
Operation and maintenance for storage facilities	28%	10%
Manufacture of animal feed	28%	12%
Transhipment	28%	12%
Poultry farming	28%	10%
Supply of goods and services to a foreign ship	28%	12%
Alternative power generating projects (as defined)	28%	12%
Unit Trusts/Mutual Funds/Unit Trust Management Companies	28%	10%
Other entities		
Charitable Institutions	14%	10%
Partnerships	-	8%
Employee Trust Fund, Provident or Pension Funds and Termination Funds	14%	10%

** The revised tax rate is applicable to a company **solely** engaged in the stated business activity.*

Annexure V - Withholding tax rates

Type of payment	Proposed rate	Prevailing rate
Dividends	• 14%	• 10%
Interest on bank deposits	• Resident individual - 5% • Any other person (other than a resident financial institution) -14%	• Companies - 10% • Partnerships/ charitable institutions/ individuals - 2.5% • Body of persons – 8%
Interest on corporate debt securities and government securities	• 14% (other than a resident financial institution)	• 10%
Interest on loans	• Residents (other than a resident financial institution) – 14% • Non-residents – 14%	• Residents – Not applicable • Non-residents - Exempt
Royalty	• 14%	• Residents – 10% • Non-resident individual – 20% • Non-resident entities – 15%
Management fees	• Residents – Not applicable • Non-residents – 14%	• Residents – 5% • Non-residents *(as fee for technical services)* – 20%
Fees for technical services	• Non-residents – 14%	• Non-residents – 20%
Fees for other services	• Residents (specified services) – 5% • Non-residents – 14%	• Not applicable
Rent	• Residents – 10% • Non-residents – 14%	• Residents – Not applicable • Non-residents – 20%
Winnings from reward, lottery, gambling, betting	• 14%	• 10%
Allocation of share of profits to partners of a partnership	• 8%	• Not applicable

**** For international transactions, the concessionary rates provided in the Tax Treaties may apply.***

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