Manual of Inland Revenue Act

(Inland Revenue Act No 24 of 2017)

Issued by the Inland Revenue Department

Prelude

The Inland Revenue Act No 24 of 2017 (the Act) was enacted by the Parliament with effect from 01.04.2018. This manual sets out very briefly the law and administrative proceedings applicable to income tax.
It also includes some useful information related to taxation on profit and gain.
This publication is comprehensive guide to the income tax. It is written in general terms having the average tax payer in mind and deals only with the provisions of the tax legislation applicable to normal situation. Therefore, it should not be regarded as a complete and authoritative statement of the law.

Ivan Dissanayake
Commissioner General of Inland Revenue
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1.2.1 Types of Persons

Under the charging provision, income tax is payable by a person. A person is defined as an individual or an entity, and includes an executor, non-governmental organization and charitable institution (s. 195(1)). An entity means a company, the charging provision is found in Chapter I of the Act (specifically, s. 2(1)), and is the central provision from which the rest of the provisions considered as branches. Generally, income tax is payable on: (a) taxable income; and (b) final withholding payments.

The distinction between taxable income and final withholding payments is important for two reasons. First, taxable income and final withholding payments may be subject to different rates of tax. The relevant rates to be applied to taxable income and final withholding payments in order to determine the income tax payable are set out in the First Schedule to the Act. Second, in computing the income tax payable by any person on taxable income for any year of assessment, such person is entitled to deduct tax credits (including any foreign tax credits) allowed to the person for that year of assessment, s. 2(3). In contrast, tax credits may not be deducted against any amount withheld on a final withholding tax payment.

partnership or trust, and therefore need not have separate legal personality. A consequence of the definition of person is that individual taxpayers are treated as separate taxable units. Chapter V of the Act sets out specific rules that govern each type of person.

1.2.2 Special Industries

In contrast to Chapter V of the Act (which provides special rules that apply to particular types of persons), Chapter VI of the Act provides special rules that are particular to certain types of activity without particular reference to the type of person conducting the activity. Division I cover petroleum operations, Division II covers financial institutions and insurance entities, and Division III covers non-governmental organizations and charitable institutions.

Chapter 2 - Income Tax Base

2.1 Taxable Income (S.3)

Taxable income of a person is defined in S.3 of the Act, which comprises of four heads of income sources assessable, namely:

(a) assessable income from employment;

(b) assessable income from business;

(c) assessable income from investment; and

(d) assessable income from other sources.

In arriving at taxable income of a year of assessment of an individual or entity, the following deductions shall be made for:

- qualifying payments, and
- reliefs

(As per section 52 of the Act and as provided in the Fifth Schedule)

In addition, only an individual if falls under following categories is entitled to subtract the tax-free threshold in arriving at the taxable income [as per subsections (2) and (3) of section 52]:

- an individual who is **resident** in Sri Lanka for a year of assessment: the aggregate relief of Rs 500,000 which is referred to in the paragraph 2(a) of Fifth Schedule.
- an individual who is **non- resident** in Sri Lanka for a year of assessment **but is a citizen of Sri Lanka:** the aggregate relief of Rs. 500,000 which is referred to in paragraph 2(a) of the Fifth Schedule.

2.2 Assessable income (S.4)

Section 4 clarifies the assessable income and the liability of both a resident person and the non-resident person for a year of assessment from an employment, business, investment or other source, which is equal to-

(a) in the case of a **resident person**, the person's income from the employment, business, investment or other source for the year of assessment, irrespective of the income source, **wherever the source arises** (i.e. worldwide basis of taxation); and

(b) in the case of a **non-resident person**, the person's income from the employment, business, investment or other source for the year of assessment, **to the extent that the income arises in or derived from a source in Sri Lanka**.

2.3 Sources of income

2.3.1 Employment income (S.5)

Calculation of an individual's gains and profits from employment for a year of assessment will be described in Chapter 3

2.3.2 Business Income

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. For more information please refer chapter 4 of this guide.

2.3.3 Investment Income (S.7)

A person's income from an investment for a year of assessment is the person's gains and profits from conducting the investment for the year. Please refer Chapter 5 for more details

2.3.4 Other income

A person’s income from other sources for a year of assessment is the person’s gains and profits from any source of any kind, however does not include profits of a casual and non-recurring nature.

The following amounts should be excluded when calculating a person’s gains or profits from investment.

(a) exempt amounts and final withholding payments; and

(b) amounts that are included in calculating the person’s income from an employment, business or investment.

2.4 General Rules

2.4.1 Concept of “Payments”

The concept of "payment" in the interpretations S. 195 is the central feature in calculating the income tax base. For example, amounts to be included in calculating a person's income are typically described in terms of payments derived. The concept of payment is intended to encompass all manners in which one person may bestow value on another person.

The **"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;

Accordingly, paragraph (a) of the definition includes not only a transfer of money or an asset but also the transfer of a liability.

Example 2.1

Mr. Perera owes Company Z RS. 100,000 payable in 1st year. Company Z is a wholly owned subsidiary of Company Y. In the normal course of his business, Mr. Perera provides services to Company Y. Instead of paying Mr. Perera for these services, Company Y agrees to assume responsibility for Mr. Perera's debt to its subsidiary Company Z. The effective transfer of the liability from Mr. Perera to Company Y is a payment from Company Y to Mr. Perera, which must be included in calculating Mr. Perera's income from his business.

Paragraph (b) of the definition includes bestowals of value similar to those in paragraph (a) but which, for technical legal reasons, may not amount to a transfer.

Example 2.2

Mr. Silva is a lawyer who provides, in the ordinary course of his profession, legal services to Company Z. Company Z is the owner of an office block. Instead of paying Mr. Silva for his services in cash, Company Z grants Mr. Silva a lease of an office on favorable terms. The lease is not owned by Company Z before it is granted to Mr. Silva and so could not constitute a transfer of the lease. Nevertheless, the granting of the lease is a "payment" from Company Z to Mr. Silva within the meaning of paragraph (b) of the definition of the term in S. 195 and Mr. Silva must include its benefit (normally the market value of the lease) in calculating his income. Similarly, if Company Z was a construction company and had built an extension on Mr. Silva's home in return for his legal services, the benefit of the extension would be treated as a payment from Company Z to Mr. Silva.

Example 2.3

> Mr. Sunil runs a grocery store. He borrowed Rs. 100,000 from Mrs. Priyanka. During a six-month period, Mrs. Priyanka buys Rs. 20,000 worth of groceries from Mr. Sunil. Instead of paying Mr. Sunil in cash, Mrs. Priyanka releases Rs. 20,000 of the debt owed by Mr. Sunil, (i.e. the loan amount due is Rs 100,00 and it is reduced to Rs 80,000 with this release). The release constitutes a payment of Rs 20,000 from Mrs. Priyanka to Mr. Sunil, which Mr. Sunil must include in calculating his income.

Paragraphs (c) and (d) of the definition similarly broaden the concept of payment to include services and use benefits.

Example 2.4

> Mr. Jagath is an executive officer of Company Z. As part of his remuneration package, Company Z provides Mr. Jagath with the use of a car and the services of a driver and a gardener. Mr. Jagath must include these benefits, (i.e. the use of the car and the services), in calculating his income from employment. The benefits will be valued using the rules in S. 27.

2.4.2 Deciding factors of the source

2.4.2.1 Employment, Business or Investment

The taxable income of a person for a year of assessment is the total of that person's assessable income for the year from "employment", "business", "investment" and "other sources". The terms "employment", "business" and "investment" are defined in S. 195. Generally, employment involves provision of labour for gain, investment involves holding assets for gain and business involves a combination of both. As the business is a combination there are difficulties in clearly defining the boundaries between employment and business on the one hand and business and investment on the other. Any income that does not fall neatly within the definition of "employment", "business" and "investment" will fall into the residual category of "other sources", unless it constitutes "profits of a casual and non-recurring nature", S. 8.

2.4.2.2 Employment or Business –

It is important to properly classify a person as an employee or an independent contractor. The employee will derive income from employment from their activities whereas the contractor will derive income from business. The rules for calculating these types of income are different and, no deductions are permitted in calculating income from employment, section 10(1)(a) since, employees have few expenses, but an independent contractor providing services may have substantial expenses for which relief is granted.

The definition of "business" in S. 195 specifically excludes "employment". Therefore, if an activity amounts to employment it cannot also be a business. The definition of "employment" in S. 195 essentially refers to the general law concept of employment. The definition also clarifies that managers of entities, individuals holding public office, and directors are employees. Past and prospective employment is also employment; as a result, amounts received either before or after employment are required to be included in income.

The concept of "employment" is a developing area of law and causes particular difficulties in classifying the status of persons who are often called "consultants". It is important to properly classify a person as an employee or an independent contractor. The former will derive income from employment from their activities whereas the latter will derive income from business. The rules for calculating these types of income are different and, in particular, no deductions are permitted in calculating income from employment (s. 10(a)(i)). This is an appropriate simple rule for employees, who typically have few expenses. An independent contractor providing services may have substantial expenses and as a result, these types of workers are not subject to the deduction prohibition and relief is granted. The distinction between employee and independent contractor (business) is also incorporated in Sri Lanka's growing network of double tax treaties.

Most substantial employers have bylaws setting out employee rights. As a general rule, persons entitled to the usual rights set out in the bylaws are employees and the IRD requires them to be treated as such. But there will be borderline cases where further investigation into a person's status is required. Investigation is particularly required of persons who are expressed to have the rights set out in the bylaws but their working conditions are inconsistent with those of a typical employee, e.g. they work few or very flexible hours or have the power to delegate their duties to a third party. Investigation is also required of those persons who do not have the rights set out in the bylaws but their working conditions are substantially the same as a typical employee, e.g. they are engaged to perform services under the direction and control of another person.

In these borderline cases, the correct approach is to weigh a series of relevant factors to determine whether on balance a particular person is an employee or not. The factors to be considered are:

(a) ***How the work is done.*** Independent contractors are told what is required but not how to do it. Employees are subject to instructions as to not only what they are to do but how they are to do it.

(b) ***Whose materials and equipment are used.*** Independent contractors use their own equipment to perform the task and purchase the materials to complete the task. Employees are provided with equipment and materials.

(c) ***Timing of Work.*** Independent contractors are told when a job must be completed but within this timeframe set their own hours (and these often do not coincide with those of normal employees). Employees are told when to work. These are typically set hours that are similar for other employees. The typical employee works fulltime.

(d) ***Who Does the Work.*** Independent contractors may hire third parties to perform the work. Employees have no power to delegate.

(e) ***Exclusivity.*** Independent contractors work for more than one client and often many. Employees typically have just one job.

(f) ***Training.*** Independent contractors arrange and pay for their own training. Employers arrange and pay for the training of employees.

(g) ***What is Paid For.*** Independent contractors are paid to produce a result for hours worked. Employees are paid to attend for a set time, typically by the week or month.

(h) ***Continuing Relationship.*** Independent contractors have a limited relationship with the contractor, typically determined by the scope of the task. Employees have a continuing relationship with their employer.

(i) ***Calculation of Remuneration.*** Independent contractors take risk and derive varying returns. Typically, their expenses are not reimbursed and they have an opportunity for profit or loss. Employees have their proper business expenses reimbursed, their remuneration is a flat amount for time worked and there is no opportunity for additional profit or loss.

No particular factor is determinative. In the vast majority of cases it will be obvious whether a person is an employee or not. The IRD is particularly interested in cases of high paid executives who argue that they are not employees.

Example 2.5

Ms A is engaged by a manufacturing company to design a new software program to support their operations. Under the agreement, she is required to be in the company office every day until the work is completed. The company provides her with general instructions on how the work is to be performed and she meets with a supervisor once a week. She is not permitted to subcontract to the work to any other person. Ms A is paid a guaranteed weekly amount and will receive a bonus if the software is completed to the company's satisfaction within 3 months. The manufacturing company provides her with any materials she needs to complete the work.

Ms A will be considered to be an employee. She is provided with guidance on how to complete the work; the company provides her with any materials she needs; she is not able to subcontract; she is paid weekly (although with a bonus on satisfactory completion), so there is no risk to her remuneration. Even though the agreement is not lengthy, the weight of the factors suggests that Ms A is an employee.

Example 2.6

Mr. Perera is an Engineer providing consultancy services on constructions to company X. During the year of assessment 2018/2019, he engaged several constructions projects and derived income according the services he provided on the submission of various reports amounting to Rs. 5,000,000. He uses his own computers and equipment's for these purposes. Moreover, it was revealed that he has provided same type of services to few other companies too.

Here, the matter in dispute is whether the income derived by Mr. Perera from company X constitutes an employment income or business income for the year of assessment 2018/2019.

Since Mr. Perara is doing his work independently by using his own equipment's in his own time framework without limiting to one client and derived his income according to his service performance, he is not an employee of the Company X.

As it has been decided that income derived by Mr. Perera for the year of assessment 2018/2019 does not falls within the meaning of employment, it becomes his business income as per the concept of dominancy over the sources of income.

2.4.2.3 Business or Investment

The definition of "business" in section 195(1) extends beyond the generic terms "trade", "profession" and "vocation" in two respects. First it includes "isolated arrangement with a business character however short the duration of the arrangement". The second extension to the definition of "business" in section 195(1) is that it includes a past business and a prospective business. So amounts derived or incurred either before or after a business must be accounted for in calculating income. This is explored further at *7.4.1* in the context of start-up costs and *7.4.6.4* in the context of the disposal of depreciable assets.

Before applying the rules that assist in determining a taxpayer's taxable income, the type of income earned must be characterized. This involves determining whether a person is engaged in sufficient activity to constitute a "business". Two key distinctions to be made here are (1) whether the person is just passively holding assets such that they have an "investment" rather than a "business" or (2) whether the taxpayer is merely engaged in a hobby, which is an activity without a source.

Dealing first with the distinction between business activities and investment, the definition of "investment" is very broad; the holding of any asset (except for an asset being the principal place of residence of an individual, subject to conditions) amounts to an investment if it is not a business. As stated above, a business is defined to include a "trade", must be understood according to its general meaning. As with employment, assessing whether a person is engaged in a trade involves

the weighing of the factors that typically indicate such activity to determine whether on balance the person is conducting a trade:

(a) ***What is Sold.*** If product sold produces no income of itself and cannot be used personally, this points to a trade. So, for example, the purchase of commercial quantities of a product that cannot be used personally would suggest a trade or at least an isolated transaction of a business character.

(b) ***Length of Ownership.*** Trades often make money through buying and selling assets. Investment involves the holding of assets. Therefore, if an asset is held for a short period of time, this suggests a trade rather than an investment.

(c) ***Repetition.*** Repetition of transactions suggests a trade.

(d) ***Supplementary Work.*** Trades often process assets to turn them into saleable products.

(e) ***Motivation for Activity.*** Trades acquire assets or conclude contracts with the intention of making a profit. Trades do not acquire assets or engage in arrangements for personal reasons such as family support, education, housing etc.

(f) ***Motivation for Sale.*** Trades typically sell assets for the same reason they acquire them, in order to make a profit. Other possible reasons for the sale of an asset should be considered such as changes in the market, changes in a work situation, family arrangements etc.

No particular factor is determinative in itself. In the vast majority of cases it will be obvious whether a person is conducting a business or not. There will be borderline cases where the taxpayers must use these factors to determine whether they have a business or investment. A typical example involves the holding of property for rent.

Example 2.7

Mr. Silva, who is resident in Sri Lanka, acquires an office building and the land of it is situated, during 1st year for Rs. 30,000,000. Mr. Silva's activities (passively renting out a property) do not fall within the definition of "business" in S.195, there is no "trade". Mr. Silva intends to hold the property, which will produce an income of itself through the rent. Further, assuming that is Mr. Silva's only office building, there is no repetition. His activities do, however, clearly fall within the definition of "investment" in S.195. At the end of 1st year Mr. Silva must calculate his income from the investment under S. 7.

The situation would be different if Mr. Silva owned and rented out 5 office buildings and managed the properties by a manager and staff. Here the repetition and active engagement of Mr. Silva with the properties would be sufficient to constitute a business of property rental. So, at the end of 1st year Mr. Silva must calculate his income from the business under S. 6.

Similar factors may be relevant in distinguishing business or investment income from hobby activities, which do not have a source. The primary factor in distinguishing income that is taxable from a non-taxed windfall is the taxpayer's motivation for the activity. Traders acquire assets or conclude contracts with the intention of making a profit. This motivation can be distinguished from activities that are hobbies. Hobby activities are undertaken for personal reasons. Therefore,

windfalls from hobby activities are usually non-recurring and casual, the taxpayer is not organized, the windfall is unexpected and unplanned, and there is no compensatory or market element to the activity.

Example 2.8.

Ms A makes pottery for her personal enjoyment. Other than regularly attending at the market, she is not organized, she does not have a strategy to earn a profit, and she has no training in pottery making. Her activities are neither a business nor investment; therefore, she is not able to claim her losses from her crafting activities.

As per the concept of dominancy, just as the definition of "employment" is dominant over the definition of "business", the definition of "business" is dominant over the definition of "investment". So, if an activity amounts to business it cannot also be an investment.
The definition of "investment" is very broad; the holding of any asset (except for an asset being the principal place of residence of an individual, subject to conditions) amounts to an investment, if it is not a business.

Example:2.9

Mr Anura is carrying out a furniture shop. He purchased a showroom in order to expand his business. Currently, he does not need all the floor space but hopes to require it all in the near future. Mr Anura rented it out the excess floor space to a saloon.
Whether this rent falls under the income of business or investment?
There is an effective connection between the rent and the business of Mr Anura because he derives this rent income in conducting the furniture shop. Hence, the rent should be included in calculating Mr Anura's income from his business.

Example:2.10

Mr Gamage runs a small Internet café and makes profits in excess of his operating capital needs. He puts some of the excess funds on deposit with a bank and derives interest from the deposit. Mr Gamage uses the remainder of the excess in purchasing a residential property. The balance part of the purchase price of the residential property is funded through a Bank loan. Mr Gamage rents out the residential property and pays the bank interest on the Bank loan.

Neither the interest on the bank deposit nor the rent on the residential property received by Mr Gamage is effectively connected with his business. so, it does not constitute a business income.

Example 2.11:

Mr.Silva is an employee in a reputed firm and he rents out his own car to a company and earned rent income. His rent income falls within the meaning of investment {7 (2)(a)} but disposal gain of such car does not falls within the meaning of any sources of income. As it is neither investment assets nor business asset.

In determining whether an amount is from an investment or business, it should be identified the connection with those types of activity. So, if an amount is derived in the context of a business, it is treated as business income irrespective of whether such returns mentioned in s. 7. The s.6(2)(g) also emphasize this idea. That is, investment type returns that are "effectively connected" with a business are treated as business income.

The "effectively connected" test is a question of nexus or association. There are varying degrees of connection and so it is not possible to state concrete rules in this area. Nevertheless, all that is required is an "effective" connection with a business and so a broad approach should be adopted. Just because a business has funds on deposit with a bank does not mean that the interest earned is not effectively connected with the business. The nexus might be broken where the funds are on fixed deposit for 3 years or more. In such a case it is still open to the taxpayer to show that there is an effective connection between the business and the interest derived. *(Ceylon Steel Corporation Limited v. Commissioner General of Inland Revenue*).

Prospective Business

What amounts to be included in a "prospective" business will be a question of fact and degree. The factors considered in determining whether a person conducts a "prospective" business are similar to those considered in determining whether a person conducts a business. These will include conducting activities on a business-like manner, with the type of activity, expected volume of trade and repetition all being considered. A profit motive is also usually a critical element in conducting a business but it is here that there might be a difference between a prospective business and actually conducting a business. With a business the person will have begun the actual activity by which a profit is expected but with a prospective business this will not be the case. A person may have a prospective business even though the actual business is never conducted.

Example 2.12

Mr. Dayan is in the middle of setting up a restaurant and Company Z approaches him. Company Z runs a chain of European cuisine restaurants within Colombo and is concerned that Mr. Dayan might prove to be serious competition in the long run. Company Z offers to purchase Mr. Dayan's prospective business and under the terms of the arrangement Mr. Dayan will agree not to open up a restaurant in Colombo for the next 15 years. Mr. Dayan accepts the offer before the restaurant is opened. Mr. Dayan still has a "prospective" business even though he never actually conducts the business. He may deduct the start-up expenses. Further, any gain he makes on the sale of his prospective business will be treated as income from a business under S. 6(2)(c). This is also true of the payment for the future restriction on his conducting the business, s. 6(2)(e).

Chapter 3 - Employment Income

3.1 What is employment?

Employment involves provision of labour for gain. The definition of "employment" in section 195 essentially refers to the general law concept of employment. This general law concept is extended to include past and prospective employment and so amounts received either before or after employment may be required to be included in income.

"employment" –

(a) means –

i. a position of an individual in the employment of another person;

ii. a position of an individual as manager of an entity;

iii. a position of an individual entitling the individual for 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

(b) includes a past, present or prospective employment.

3.2 Gain and profits (section 5)

3.2.1 Items included

The following benefits received or derived from employment are taxable as income from employment:

- Salary, wages, leave pay, overtime pay, fees, pensions, commissions, gratuities, bonuses, and other similar payments;
- 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;

Example 3.2.1.1

Mr. Silva is an executive officer of Company X. As part of his remuneration package, Company X provides Mr. Silva with a car and the services of a driver and a gardener. Mr. Silva must include these benefits (use of the car and the services) in calculating his income from employment under section 5(2)(h) and valued under section 27.

- Other payments, including gifts, received in respect of the employment;
- The market value of shares, at the time they were 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;

Example 3.2.1.2

Mr. Perera is employed as a manager of Company Z. During 1st year Mr. Perera receives as part of his remuneration package an option to acquire 1,000 shares in the Company at a price of Rs 500 per share. At the time of receipt, the market value of the options is Rs. 300,000. In the middle of 2nd year Mr. Perera exercises the options by paying Rs. 500,000 and receives 1,000 shares in Company Z. The market value of the shares at the time of allotment to Mr. Perera is Rs. 800,000.
The receipt of the options during 1st year is a benefit in-kind but Mr. Perera need not include the value of the options in calculating his income from the employment in 1st year, under section 5(3)(e). However, Mr. Perera will need to include as his assessable income from employment an amount equivalent to the market value of the shares at the time of allotment (i.e. Rs. 800,000), less the consideration paid by Mr. Perera upon exercising the options (i.e. Rs. 500,000), which works out to be Rs. 300,000.

- 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 Commissioner General of Inland Revenue.

3.2.2 Items excluded

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.

Related case law

Kanakasabapathy vs CGIR 4 SLTC 140
N. E. Weerasooriya vs CGIR 4 SLTC 82
P. M. Jeyarajan vs CGIR 4 SLTC 257
Shilton vs Wilmshurst 64TC 78

3.2.3 Value of Benefits (section 27)

(a) value specified by the Commissioner General
(b) in any other case according to market value

3.2.4 Deductions

No expenses are deductible in ascertaining employment income in terms of section 10.

3.3 Pre-and post-employment receipts

Almost all amounts that are derived in respect of employment must be included in calculating employment income under section 5. For this purpose, as discuss in following examples, the concept of "employment" itself is very broad and encompasses both "prospective" and "past" employment.

Example 3.3.2.1 – Prospective Employment

Mr. A works for a large accounting firm. Company Z, a rival accounting firm, wishes to recruit Mr. A and they approach him. Mr. A is reluctant so Company Z tries to convince him by giving him a new motorcycle for agreeing to commence employment with them in 3 months. The market turns and by the end of 3 months Company Z no longer wishes to employ Mr. A and so Mr. A stay with his current firm. Mr. A has a prospective employment with Company Z at the time he is given the motorcycle. A prospective employment is an "employment" for the purposes of s. 195(1). Therefore, the value of the motorcycle must be included in calculating Mr. A's income from the employment with Company Z, section 5(2).

Example 3.3.2.2 – Past Employment

Mr. Perera worked for Company A, a firm of engineers, for 30 years until he left their employ last year to pursue his lifelong dream to write a novel. Mr. Perera continues to refer enquiries and acquaintances regarding engineering matters to Company A. In appreciation for this and all his work over the years, Company A gives Mr. Perera a 3% commission on fees charged to his referrals. Mr. Perera has a past employment with Company A. This is an "employment" for the purposes of section 195(1). Therefore, Mr. Perera must include the commissions in his income from the employment with Company A, under section 5(2).

3.4 Basis of payment

Income from employment of **an individual should be account for income tax purpose on cash basis** under section 21(2).

Example 3.4.1

Mr. Silva is an employee of ABC Company. The company paid bonus of Rs 500,000 in December 2017. Out of the profit earned for the year of assessment 2016/2017. Mr. Silva is liable to tax on this bonus for the year of assessment 2017/2018 and ABC Company must deduct WHT on this bonus for the month of December 2017.

3.4.1 Withholding by Employer

Section 83 instructs employers to withhold tax from income from employment at the rates specified by the Commissioner General as per First Schedule to the Act. An employer must provide an employee with a withholding tax certificate not later than thirtieth day of April of that year, or where an employment ceases during the year of assessment, not more than 30 days from the date of cease of the employment. The withholding tax certificate must be in the required form and contains pertinent information in relation to the withholding tax affairs of the employee in respect of that employment, including the amount of income received by the employee for that year of assessment and the amount of tax withheld.

A resident individual who only has income from employment that is subject to withholding by employer for a year of assessment will not be required to file a return for that year of assessment, section 94(1)(a)(ii).

3.4.2 Aggregate reliefs referred to in section 52 (schedule 5)

(a) Personal relief of Rs. 500,000 for each year of assessment

This relief is available for resident individuals and for individual who is not resident in Sri Lanka but is a citizen of Sri Lanka

(b) Relief of Rs. 700,000 for each year of assessment

This relief is available for resident individual with income from employment

3.5 Treatment for Retirement Benefits

Profit from employment include certain lump sum receipts of an employee at retirement. These receipts are profits for the year of assessment in which they received. Retirement benefits other than compensation is taxed at lower rates. Compensation is taxed at lower rate if the employer has made such payments in accordance with a scheme, which is uniformly applicable to all his employees. Where the employer does not have a uniformly applicable scheme for the payment of compensation for loss of office, it should be taxed at normal rates.

i. Retiring gratuity
ii. Commuted pension
iii. Compensation for loss of office or employment
iv. Withdrawals from Employees Trust Fund

Lower rates applicable for retirement benefits

(a) where the period of contribution or the period of employment is 20 years or less

Total Income from Employment	Tax Payable
On the first Rs. 2,000,000	Nil
On the next Rs. 1,000,000	5%
On the balance	10%

(b) where the period of contribution or the period of employment is more than 20 years

Total Income from Employment	Tax Payable
On the first Rs. 5,000,000	Nil
On the next Rs. 1,000,000	5%
On the balance	10%

3.6 Exemptions relevant to employment income (Third Schedule)

- Compensation or gratuity paid in lieu of personal injuries or death.
- Amounts paid on retirement from any provident fund approved by the Commissioner General of Inland Revenue.
- 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.
- Pension received from the Sri Lankan Government or from a Department of the Government.
- 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.
- Employment income of expatriate employees (up to a maximum of twenty employees) who are working in a company which has incurred expenses exceeding USD 1,000 Mn on depreciable assets (other than on intangible assets) in Sri Lanka or a state-owned company entitled to an enhanced capital allowance as stated above,

3.7 Pay – As – You Earn scheme

Income tax payable by an employee on his employment income under the provisions of this scheme is deducted by the employer at the time of payment or credited. Tax so deducted each month represents the income tax payable by the employee on that part of income.

Employment income is thus taxed, as it is earned, by withholding the tax at source.

3.8 More than one employment

3.8.1 Primary Employment

Each employee must designate his or her employment, or in the case where the employee has multiple employments, one of his or her employments, as a "primary employment" by providing a declaration to the employer nominating such employment as the employee's primary employment ("primary employment declaration"). An employee can only have one primary employment at any one time and once nominated, such employment will remain as the employee's primary employment until expressly withdrawn. Employee also need to provide the withholding tax certificate issued by the former primary employer for that year of assessment. The new primary employer must take into consider the income and tax withheld by former primary employer when calculating the employee's tax to be withheld for that year of assessment at the appropriate rates in the tax tables specified by the Commissioner General of Inland Revenue.

Where an employee ceases his or her primary employment and commences a new employment within the same year of assessment, the new employer can treat the employment as a primary employment if the employee provides the new employer with a new primary employment declaration and withholding tax certificate(s) issued by the former primary employer(s) in respect of the former primary employment(s) for that year of assessment. The new primary employer must, for the purposes of calculating tax to be withheld under s. 83, add to the income from the new primary employment for the year of assessment all income from the employee's former primary employment as well as add to the tax considered to be withheld by the new primary employer all tax withheld by the employee's former primary employer, based on the information set out in the withholding tax certificate issued by the former primary employer.

3.8.2 Secondary Employment(s)

Any employer that is not presented with a primary employment declaration will be treated as a secondary employment must withhold tax on that employee's income from such secondary employment in accordance with the following:

(a) where the monthly payment to the employee is less than or equal to LKR 50,000 per month, at 10%; or

(b) where the monthly payment to the employee exceeds LKR 50,000 per month, at 20%.

3.9 Employer's Obligations

i. Deduct income tax from the gross remuneration of the employees, who are liable to pay income tax according to tables provided by the Commissioner General of Inland Revenue.

ii. Maintain proper records on the specified forms in respect of each employee who is liable tax and remit the taxes deducted in any month on or before the 15th of the following month.

iii. Furnish annual declaration on or before the 30th of April every year.

iv. Issue a withholding tax certificate on tax deduction to 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 ceases his employment.

Chapter 4 - Business Income

4.1 What is Business Income?

Business income is defined in the Act as follows

"business"

(a) Includes

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

ii. a past, present or prospective business; but

(b) excludes an employment;

According to the above definition, it is important to understand the business in terms of "trade", "profession" and "vocation". These terms must be understood according to its general meaning.

It also includes "isolated arrangement with a business character however short the duration of the arrangement".

Further, the definition of "business" is extended to include a past business and a prospective business. So, amounts derived either before or after a business must be accounted for in calculating income (Prospective business will be discussed in item 4.1.2.)

The definition of business specifically excludes "employment". So, if an activity amounts to employment, it cannot also be a business. Likewise, if an activity amounts to business it cannot also be an investment.

This is because of the concept of dominancy over the sources of income. That is, the definition of "employment" is dominant over the definition of "business" and the definition of "business" is dominant over the definition of "investment".

4.1.1 Trade, Profession and Vocation

4.1.1.1 Trade

The factors to be considered in deciding whether an activity amounts to a trade are mentioned in the chapter 2.4.3

No particular factor is determinative in itself. In the vast majority of cases, it will be obvious whether a person is conducting a business or not. In some circumstances, the existence of one single badge is enough to show trading. In other cases, a combination of the badges of trade need

to be looked into. However, these tests have to be applied having regard to the relevant facts and circumstances of each case.

References:

Ruthledge v. CIT (14 TC 490)
Leeming v. Jones (15 TC 33)
Edward v. Bairstow & Harrison (36 TC 207)
Mahawitharane v. CIR (3SLTC 156)
Ram Iswara v. CIR (3 SLTC 241)

4.1.1.2 Profession & Vocation

The Act does not define Profession and Vocation. Both vocation, as well as profession, indicates the career or the occupation through which an individual makes a livelihood, vocation is a broader term than profession. A profession is an occupation that requires extensive training and the study and mastery of specialized knowledge, and usually has a professional association, ethical code and process of certification or licensing. Further they practiced on the basis of relevant professional qualifications in a personal, responsible and professionally independent capacity by those providing intellectual and conceptual services in the interest of the client and the public". A vocation is an occupation, either professional or voluntary, that is carried out more for its altruistic benefit than for income, which might be regarded as a secondary aspect of the vocation, however beneficial. Vocations can be seen as fulfilling a psychological or spiritual need for the worker, and the term can also be used to describe any occupation for which a person is specifically gifted, in other words born with talents, and usually implies that the worker has a form of "calling" for the task.

4.1.2 Prospective business

As per the definition, "Business" includes prospective business. It is an expanded concept of business. What amounts to a "prospective" business will be a question of fact and degree. The factors considered in determining whether a person conducts a business may applicable to determination of whether a person conducts a "prospective" business. However, when considered the profit motive factor, there might be a difference between a prospective business and an actual business. With an actual business, the person will have begun the actual activity by which a profit is expected but with a prospective business this will not be the case. A person may have a prospective business even though the actual business is never conducted.

Example 4.1.2.1

Ms Rita runs a reputed restaurant and catering business in Colombo and wishes to open a new restaurant in Kandy. Mr John is the market leader for the same type of business in Kandy. He concerned that Ms Rita might prove to be a serious competitor in the long run. Therefore, Mr John offers to purchase Ms Rita's prospective business and under the terms of the arrangement Ms Rita will agree not to open up a restaurant in Kandy for the next 5 years. Ms Rita accepts the offer before the restaurant is opened and she still has a

"prospective" business even though has not actually conducted the business. This is also true of the payment for the future restriction on her conducting the business.

The expenses she made for the prospective business can be deducted from such business receipt (payment for the future restriction on her conducting the business). And if she made loss from the prospective business, such loss can be deducted from the profit, if any, from her other business.

4.2 Deciding facts of Business income

There are difficulties in clearly defining the boundaries between employment and business on the one hand and business and investment on the other. This will further explain under chapter 2.4.2

4.3 Gains and Profits from Business

All gains and profits from conducting the business for the year of assessment has to be taken in to account in computing the business income. Section 6 expressly required to **include** the following items as gains and profits from conducting a business for a year of assessment.

(a) Sale of any goods or article and receipts by providing a service including mixed receipts;

(b) consideration received in respect of trading stock;

(c) from the realisation of capital assets and liabilities of the business as calculated under Chapter IV

(d) amounts required to be included by the Second or Fourth Schedule of the Act on the realisation of the person's depreciable assets of the business; (will be discussed 4.4.2.4.)

(e) amounts derived as consideration for accepting a restriction on the capacity to conduct the business;

(f) gifts received by the person in respect of the business;

Example 4.3.1

The company ABC is engaged in the business of selling furniture. The company regularly purchase cushions for the manufacturing furniture. The company has been selected as the best purchaser of the cushion manufacturer and therefore, received a small motor lorry as a gift.

(g) amounts derived that are effectively connected with the business and that would otherwise be included in calculating the person's income from an investment;(eg. Penalties, surcharges or default interest derive by conducting the business, Government grants derived by the business).

(h) other amounts required to be included under this Act.

These will include;

a partner's share of partnership income to the extent that such partnership income comprises income from a business of the partnership, s. 55(1);

viii. gains on disposal of an interest of a partner in a partnership as calculated in accordance with Chapter IV and s. 56, s. 55(2);

ix. amounts derived by a trust to which a beneficiary is presently entitled (see *3.4.1* below) that would otherwise be treated in the hands of the trust as income from a business, s. 57(1);

x. distributions of a non-resident trust to a beneficiary to the extent that underlying income has not been subject to tax in the hands of the trust or the trustee and the interest is effectively connected with a business of the beneficiary, s. 58(1)(b);

xi. gains on disposal of interest of a beneficiary in a trust where the interest is effectively connected with a business of the beneficiary, s. 58(2);

xii. distributions of a non-resident company to a shareholder, where the shares are effective connected with a business of the shareholder, s. 61(1)(b); and

xiii. gains on disposal of interest of a shareholder in a company where the interest is effectively connected with a business of the shareholder, s. 61(2).

In calculating a person's gains and profits from conducting a business for a year of assessment the following shall be excluded:

(a) exempt amounts and final withholding payments; and

(b) amounts that are included in calculating the person's income from an employment.

4.4 Deductions

Deductions will be discussed relevant to the all source of income, generally deduction of the act falls in to three main categories

- General deductions (s.10)
- Main deduction (s.11)
- Other deductions including specific deductions (s.12-s.19)

4.4.1 General deduction rules

Section 10 provides general deduction rules in calculating profits and income of a person. Basically, four general rules have been set out in s.10.

i.

(a) No deduction shall be made in calculating a person's income from employment.

(b) Certain specific deductions are not allowable in calculating a

person's income (will be discussed under item no.....)

ii. A deduction for a payment shall not be allowed until the tax, if required, withheld has been paid to the Commissioner General.

iii. No deduction shall be allowed except as expressly permitted by the Act.

iv. Where more than one deduction applies, the most specific deduction shall be applied even if that results in the denial of a deduction (Refer Examples 11 and 12)

Section 10(1)(b)

The Following deductions shall not be made in calculating a person's income.

1. Domestic expenses (refer item 4.4.1.1)

   i. Tax payable under the Inland Revenue Act. (This includes instalment, interest, penalty, WHT including PAYE tax paid by any employer in respect of the employment income of any employee).

   ii. Interest, penalties and fines payable to a government or a political subdivision of a government of any country for breach of any written law.

   iii. Expenditure incurred on tax exempted income and income relating to the final withholding payments.

   Example 4.4.1.1

   Nations' Bank, licenced commercial bank in Sri Lanka, has invested in sovereign bonds and shares in resident companies. During the Y/A 2018/19, the bank has earned interest income from sovereign bonds and dividend income from shares invested in resident companies. Such business receipts represent the exempted income and final withholding payments respectively.

   Hence, the Bank is not allowed to deduct expense incurred by the Bank to earn such exempt amount and final withholding payments from the profit of the Bank liable to tax.

   iv. retirement contributions, If such contribution;
   (a) has not considered as a benefit of an employee; or
   (b) is a contribution made by the employer to a pension, provident or saving fund or to a provident or saving society not approved by Commissioner General?

   v. Dividends of a company.

   vi. Entertainment expenses and outlays-

   "entertainment" means the provision to any person of food, beverages, tobacco, accommodation, amusement, recreation or hospitality of any kind" (S.195).

   vii. Transfers to reserves or provisions for future expenditure or losses which has not incurred during the year of assessment.

   viii. Amounts incurred on lotteries, betting or gambling, other than amounts incurred from conducting a business of lotteries, betting or gambling.

ix. Taxes or other levies specified by the Commissioner-General.

4.4.2 Domestic expenses

Section 197 defined the Domestic Expenses as follows.

(A) Where an individual incurs expenditure in respect of himself, the expenditure shall be domestic expenditure to the extent that it is incurred –

i. in maintaining the individual, including in providing shelter as well as meals, refreshment, entertainment or other leisure activities;

ii. in the individual commuting from home;

iii. in acquiring clothing, including shoes, for the individual, other than clothing that is not suitable for wearing outside of work;

iv. in educating the individual, other than education that is directly relevant to a business conducted by the individual and that does not lead to a degree or diploma; or

v. in paying any personal debts, including credit card debts, of the individual.

These are the expenses incurred by a self-employed person on his or her own behalf. So, such expenses contain prohibition on deductibility. However, some expenses contain limited exception to the prohibition. The following examples elaborate such limited exception.

(a) As per item no 1(A)(iii), cost of clothing is not deductible unless it is unsuitable to wear outside of work. So, this rule does not prohibit protective clothing. Ex. The cloak worn by medical practitioners.

Similarly, the rule does not prohibit a deduction for the cost of clothing that forms part of a service provided, such as the costumes worn by performers.

The rule does prohibit only the expenses incurred by self-employed persons for cloths which are suitable to be worn outside of work also.

Ex. Cost of Suits made by Lawyers, Medical Consultants.

(b) Item No.1 (A)(iv) prohibits the deduction for the expenses made by the individual in educating himself. But, it does not prohibit the expenses made for the education that is directly relevant to business conducted by the individual and that does not lead to a degree or diploma.

For example, expense made for the usual type of training taken by professionals to keep up-to-date and which is directly relevant to the business in question is not prohibited.

e.g. the cost of a training course offered to lawyers on recent changes in the law is not prohibited but cost for a course on creative writing is prohibited and so not allowable.
Further, a deduction is also denied if the education is part of a course leading to a degree or diploma.

(B) Where another person incurs expenditure in making a payment to or providing any other benefit for an individual, the expenditure shall be domestic expenditure except to the extent that –

i. the payment or benefit is shall include in calculating the income of the individual;

ii. the individual provides consideration of an equal market value for the payment or benefit; or

iii. the amount of the expenditure is so small as to make it unreasonable or administratively impracticable to account for it.

These are the expenses incurred by a person on behalf of an individual's benefit. Individual's such benefit constitutes a "payment" from the person who made it and therefore, becomes an expense incurred by such person.

Tax treatments on such expenses with special attention to the above three exceptions are elaborate by following examples.

Example 4.4.2.1

Company A employs Mr Z. It provides Mr Z with private use of a company car and, along with other employees, meals provided on Company A's premises. Both the use of the company car and the provision of the meals are payments from Company A to Mr Z. The use of the company car is included in calculating Mr Z's income from employment under s. 5(3)(h) and valued under s. 27.

Accordingly, because of the exception referred to in item 1(B)i, Company A is not precluded from claiming a deduction for expenses incurred in making the car available to Mr Z, i.e. maintenance expenses.

But, as per s. 5(4)(d), no amount is required to be included in Mr Z's income with respect to the meal benefits. As a result, Company A is not allowable to deduct expense incurred in providing meals to the employees including Mr. Z.

Example 4.4.2.2

Mr A runs a restaurant. He regularly permits members of his family to dine free of charge with his paying customers. The meals provided by Mr A constitute a payment from him to both his paying customers and his family members.

Mr A's paying customers pay market value in consideration for their meals. As a result, Mr A is not precluded from deducting expenses incurred in providing the meals to his paying customers as per item no 1(B) (ii). In the normal course, such expenses would be deductible under s. 11 too.

But, because Mr A's family members do not pay for their meals, Mr A is precluded to deduct expenses incurred in providing meals to his family members.

(C) Expenditure referred to in (A) and (B) shall include interest incurred with respect to money borrowed that is used in a manner referred to in those subsections.

4.4.3 Main deduction rule

Section 11 is the main deduction rule in the Act. The section is critical importance in calculating business income under the Act. This is because no amount is allowed as a deduction in calculating income except as specifically authorized under the Act (S.10(3). Hence, as this section 11 is available in the Act, subject to the conditions specified in the section, expenses of the business or investment can be deductible in ascertaining the income from business or investment.
Section 11 specifies as follows;

"*(1) In calculating a person's income from a business or investment for a year of assessment, expenses to the extent they are incurred during the year by the person and in the production of income from the business or investment, shall be deducted.*

(2) No deduction shall be allowed under subsection (1) for an expense of a capital nature.

(3) In this section, "expense of a capital nature" includes an expense that secures a benefit capable of lasting longer than twelve months".

4.4.3.1 Main aspects of the Section 11.

i. Expenses of a capital nature is not allowable.

Under, section 11(2), expenses of a capital nature cannot be deducted. As per section 11(3), "expense of a capital nature" includes an expense that secures a benefit capable of lasting longer than twelve months".

However, this does not necessarily mean that an expense which secures a benefit lasting twelve months or less is revenue in nature and wise versa. In determining whether such an expense is revenue or capital in nature, the various tests under case law, such as the fixed or circulating asset test, enduring benefit test and once-and-for-all test, will continue to apply.

Reference:

Van Den Berghs Ltd V clark (19 TC 390)
Barr Crombie & Co Ltd V CIR (26 TC 406)
Short Brothers Ltd V The CIR (12 TC 955)

Vallambrosa Rubber Co Ltd V Farmerb (5TC 529)
Atherton V British Insulated and Helsby Cables Ltd (10 TC155)
Heather V P.E. Consulting Group Ltd (48TC 293)

ii. "Actual cost" are eligible for deduction.

As per section 11, only "actual costs" are eligible for deduction. So it will not permit the deduction of "notional" costs, such as those put to a reserve. This is confirmed by section 10(1)(b)(viii) too.

iii. Possibility of an apportionment. ("to the extent they are incurred").

This means that under section 11, expenses are allowed "to the extent they are incurred".

Example 4.4.3.1.1

A person who has home office and incurs expenses in common for the business and home must apportion the expenses between business and home. And, only the expense attributable to the business is allowed to deduct under section 11).

iv. Expenses must be incurred "in the production of Income".

This means the section 11 requires the expenses to be incurred in the production of income from business or investment. Production of income generally refers to the intention to make a profit or gain. But, this does not mean that the business or investment actually be profitable in the year the expense is incurred in order to be eligible for a deduction. What is required is that the costs are incurred as part of the activity that is intended to make the profit or gain.

It is because of this reason; start-up cost of a business is allowed as a deduction under section 11.

v. The section is "Residual" in nature.

The section 11 is "residual" in nature. This means, if another provision of the Act denies a deduction then Section 11 will not permit a deduction. This is because of the operation of section 10(4) of the Act.

"Where more than one deduction applies, the most specific deduction shall be applied even if that results in the denial of a deduction" [10(4)]

Particularly, sections 12 to 19 of the Act are called as specific deduction provision of the Act. Accordingly, if an expense is of a particular kind that is dealt with in one of those sections then, as the more specific provision, that section must be used irrespective of whether the result is the granting or denial of a deduction. In such a circumstance, section 11 has no application and so become "residual".

Example 4.4.3.1.2

Section 11(2) does not permit deductions for capital nature expenses. As per the definition in section 11(3), expense made for acquiring capital asset is a capital nature expense. If a debt obligation has been incurred to acquire such a capital asset, then interest made there on also becomes a capital nature expense. As per section 11(2), such capital nature expenses cannot be deducted.

However, section 12 of the Act deals with the interest deduction. As per the section 12(a), interest on a debt obligation which has been incurred to acquire an asset is deductible if such asset is used during the year in the production of income. Accordingly, even if capital nature expenses denied by section 11, section 12 grant such expenses being the most specific section applicable to interest deduction.

Example 4.4.3.1.3

In case of a person who is carrying on a business of hiring vehicles, cost of repairs is an expense incurred in production of income. Hence, such expenses should be considered under section 11. However, Section 14 deals with the expenses for repairs or improvements. Hence, repair expenses can only be deducted subject to the limitation specified in section 14.

Accordingly, even if the section denies the expense (portion of the expense), section 14 is applicable as the most specific section in respect of repairs.

4.4.4 Special Deduction rules

4.4.4.1 Interest Expenses

Section 12 and 18 deals with the deductibility of interest.

Section 12

i. As per the section 12, the relevant debt obligation should be incurred for following purposes only;
ii. The borrowed money should be used to acquire an asset that is used during the year in the production of income; or and
iii. The borrowed money should be incurred in the production of income.

Example 4.4.4.1.1

Mr. Sunimal is carrying on a business of selling of computer accessories. He obtained a bank loan and utilised the loan proceeds as follows during the year 18/19.

50% for construction of new office building.

25% for payment of salaries to the staff.

25% for his private purposes.

During the year of assessment 2018/2019, he paid Rs. 300,000 as interest for the loan. During the year of assessment 2019/2020 he sold the office building. and Paid the loan interest for the year is Rs. 250,000.

During the year of assessment 2018/2019, under Section 12(a) Mr. Sunimal is entitled for a deduction amounting to Rs. 150,000 (50% of the Loan) paid as interest on the funds used to construct the new office building as it is an asset used during the year. Similarly, s. 12 (a) permits a deduction for the interest paid on the funds used to pay the staff salaries amounting to Rs. 75,000 because those funds are used in the production of income from the business. Interest paid amounting to Rs. 75,000 on the funds used for his private purposes is not deductible.

Further, he is not entitled for a deduction of Rs. 125,000 paid as interest on the funds utilized to construct the office building during the year of assessment of 2019/2020 as such building is not used during the relevant year in the production of income for the business.

Section 18

In addition to the section 12, Section 18 is also applicable only for entities on deductibility of interest expense.

Restricts the deductibility of interest deducted in calculating an entity's income on financial instruments. This is called as thin capitalization rule. The rule is applicable as follows;

For Manufacturing Entities

Allowable Finance Cost attributable to financial instruments = (Total Financial Cost/Total Cost of Financial Instruments) X [(Total of the issued Share Capital and reserves) X 3]

For Other Entities

Allowable Finance Cost attributable to financial instruments = (Total Financial Cost/Total Cost of Financial Instruments) X [(Total of the issued Share Capital and reserves) X 4]

Any deduction unutilized in the current year ~~will~~ may be carried forward up to six years, subject to the same thin capitalization restriction.
This thin capitalization rule does not apply to Financial Institutions.

Example 4.4.4.1.2

Company B is a garment factory and incurs interest expense (for what) amounting to Rs. 2,500,000 during the year of assessment 2018/2019. Balance Sheet of the company as at 31.03.2019 revealed as follows.

Stated Capital 5,000,000

Revenue Reserves 3,000,000

Long Term Loans 30,000,000

Finance Cost attributable to financial instruments = (Rs. 2,500,000/Rs. 30,000,000) X [(Rs. 5,000,000+ Rs. 3,000,000) X 3]

Finance Cost attributable to financial instruments which is allowable to deduct in Y/A 2018/2019 = Rs. 2,000,000.

Balance Rs. 500,000 can be carried forward to Y/A 2019/2020 and so on up to 2025/2026, and deductible subject to the same above basis. That means, the amount of Rs. 500,000/- is added to the financial cost that will be incurred in next year and so on.

4.5 Trading Stock

"Trading stock" is also an asset for a business. Section 197 Defines it as *"assets owned by a person that are sold or intended to be sold in the ordinary course of a business of the person, work in progress on such assets, inventories of materials to be incorporated into such assets and consumable stores".* Further, definitions of "depreciable asset" and "business asset" excluded the trading stocks from such assets. The definition of trading stock incorporates the traditional distinction between circulating assets and fixed assets. Trading stock constituting circulating assets. This means that the classification of an asset as trading stock or otherwise will differ depending on the nature of the business in which it is held. For example, land held in the context of a business will typically be a "business asset" rather than "trading stock". However, in the hands of a property developer, land will constitute trading stock.

Generally, s. 13 delays a deduction for the cost of trading stock until it is disposed of. Section 13 also provides rules for determining the cost of trading stock and such rules are follows the generally accepted accounting principles.

4.6 Research and Development

Research and development defines in section 15 as follows;

"research and development expenses" means expenses incurred by the person in –

(a) carrying on any scientific, industrial, agricultural or any other research for the upgrading of the person's 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

(b) the process of developing the person's business and improving business products or process which shall be beneficial to Sri Lanka,

but shall exclude expenses incurred that are otherwise included in the cost of an asset under this Act.

The section 15 is one of the specific section of the Act. The special feature of the section is that it permits the research and development cost even if it a capital nature expense. However, it does not allow to deduct the cost of purchasing of equipment used for the research. But, the section allows the cost of the assets like intellectual property that is created by the research and development.

Further, under sixth schedule, a person is entitled for an additional deduction which is equal to the 100% of the total amount of research and development expenses for three years after 01.04.2018 as a temporary concession and it will expire 31.03.2021.

Example 4.6.1

Company A formed during year 2018/2019 for the purposes of researching and developing a new fertilizer. The research and development is a two-year process. During year 1, Company A incurs expenses in developing the new fertilizer of LKR 5,000,000, including wages for researchers, the rental of a laboratory, legal fees and materials. However, the research for this year is unsuccessful.

Company A is allowed to deduct LKR 5,000,000 expenses incurred during year 1 as these expenses fall within the definition of "research and development costs" in s. 15.

During year 2, the Company spends a further LKR 10,000,000 in research and development costs and this time the research is successful. It has its research patented. The cost of the patent is Rs. 10,000,000/-. It is the intellectual property that is created by the research and development. Hence, that cost can be deducted under section 15. However, even though, it becomes depreciable asset of the company, depreciable allowance cannot be claimed for the second year as cost of assets has been allowed to deduct for the second year During year 2 the Company sells a permanent exclusive license to use the patent in India to Taj Industries for LKR 20,000,000.

4.7 Agricultural startup expenses

For any kind of business, start-up expense is allowable to deduct under section 11. But, under section 11, capital nature expenditure included in start-up expense is not deductible. But, section 15, as the most specific section, is applicable on agricultural start-up expenses and as such, even capital nature expenses included in agricultural start up expenditure is deductible.

4.8 Depreciation allowances and balancing allowances

As per section 16, depreciation allowances and balancing allowances are allowed to be deducted in calculating a person's income from a **business** only-

Depreciation allowance are-

(a) granted in respect of depreciable assets owned and used by a person at the end of a year of assessment in the production of the person's income from a business; and

(b) calculated in accordance with the provisions of the Second or Fourth Schedule to this Act.

Depreciable asset is defined as

"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 excludes goodwill, an interest in land, a membership interest in an entity and trading stock."

Accordingly, following conditions has to be considered in respect of the depreciable asset, when claiming the depreciation allowances.

- Ownership of the assets should be available to the relevant person -Legal ownership or ownership of the asset in any other way as specified in the Act.

  As per S.49(2), lessee has the ownership of assets obtained on finance lease.
- Used by the person for production of income.
- If any depreciable asset is entitled for a deduction of depreciation allowance, then such claimable cannot be differed for future periods.

Please refer chapter 5 for more information.
According to the fourth schedule to the Act, following should be considered in calculating the depreciation allowance.

1. Straight line method and following formula should be used.

   Depreciation allowance =A/B

   A - Depreciation basis of the asset at the end of year of Assessment.

   B - Number of years relevant to each depreciable asset

2. Full Depreciation allowances will be granted for the year of acquisition if such depreciable assets used up to the end of the year of assessment. No depreciation allowance will be granted for the year of disposal as such asset is not exists at the end of the year of assessment.

3. No depreciation is allowed on road vehicle.
   "Road vehicle" does not include

   i. a Commercial vehicle

Commercial vehicle means a road vehicle designed to carry loads of more than one or more than 13 passengers or vehicle used in transportation or vehicle rental business

ii. a bus or minibus

iii. a goods vehicle

iv. a heavy general purpose or specialised truck or trailer.

4. Depreciation basis of a depreciable asset shall be the sum of

   i. Depreciable basis (written down value) of the asset at the end of the previous Year of Assessment; and

   ii. Amounts added to the depreciation basis of the asset during the year of assessment in respect of additions to the cost of asset.

Example 4.8.1

The ABC is a garment factory. It acquired a machinery in 01.06.2018 at a cost of Rs. 1,000,000/- and used it in the production of income. Suppose it continually use it for next five years, the depreciation allowance is calculated as follows;

Year of Assessment	Depreciation basis	No of Years	Depreciation for the year	Cumulative Depreciation
2018/2019	1,000,000	5	200,000	200,000
2019/2020	800,000	4	200,000	400,000
2020/2021	600,000	3	200,000	600,000
2021/2022	400,000	2	200,000	800,000
2023/2024	200,000	1	200,000	1,000,000

Balancing allowances

Where a depreciable asset of a person is realized by the person before the end of a year of assessment, balancing allowance is calculated as follows,

Balancing allowances (Disposable Loss)

Balancing allowances = {written down value of the asset - consideration received for the asset}

When realizing a depreciable asset, where consideration received exceeds the written down value, it is called as assessable charges (Disposal profit) and taxable as a business receipt.

Assessable charges (Disposable profit)
Assessable charges forms part of the person's business income and will be calculated in accordance with the following formula:
Assessable charges = {consideration received for the asset - written down value of the asset}

4.9 Repairs and Improvements

Section 14 is a specific provision applicable for the deductibility of expenditure on repairs and improvements. This means that if an expense falls within the scope of s. 14 then the expense may only be deducted as provided for by s. 14 and not under the general deduction rule in s. 11.

Conceptually, repairs do not improve the value of an asset but only maintain it. By contrast, improvements enhance the value of an asset. It may be difficult to draw a distinction between repairs and improvements therefore Section 14 makes drawing this distinction irrelevant. It can be deducted both repairs and improvements but subject to the limitation in s. 14(2).

Limitation of the deductions

- On Buildings, structures and similar depreciable assets (Class 4)

  The deductions shall not exceed five percent (5%) of the written down value of the asset at the end of the previous year or actual repairs and improvement expenses incurred during the YA which ever less.

- On all other depreciable assets.

The deductions shall not exceed twenty percent (20%) of the written down value of the asset at the end of the previous year or actual repairs and improvement expenses incurred during the Y/A whichever less.

The residual of repairs and improvement expense for which a deduction shall not be allowed as a result of the limitation shall be added to the depreciation basis of the asset.

Example 4.9.1

Consider the above example 15 and it will be required a repair amounting to Rs.400,000/- in the Year of Assessment 2020/2021.

The repair expence and depreciation allowance deductable under section 14 and 16 respectively is as follows;

During the year of assessment -2020/2021, the Cost of repair	400,000
Written down value of the Asset as at the end of previous year	800,000
Allowable repair cost (800,000 *20%)	160,000
Excess repair cost to be added to the depreciable basis	240,000

Depreciation allowance to be granted for the remaining Years of Assessment

Year of Assessment	Depreciation basis	No of Years	Depreciation for the year	Cumulative Depreciation
2018/2019	1,000,000	5	200,000	200,000
2019/2020	800,000	4	200,000	400,000
2020/2021	600,000	3	200,000	600,000
2021/2022	640,000	2	320,000	920,000
2023/2024	320,000	1	320,000	1,240,000

Accordingly,Repair and improvement expense made after the expiration of the no of years (in this case 5 years) ***will not be allowed*** *as value for depreciation basis and number of years are zero.*

4.10 Losses

Section 17 provides the deduction of **loss from the realization of asset and liabilities** in calculating the person's income from business.

The assets and liabilities are-

(a) Capital assets of a business to the extent to which the assets were used in the production of income from business. (exclude the personal usage)

(b) In the case of a liability 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.

(c) In the case of any other liability, the liability was incurred in the production of income from the business.

Section 19

Section 19 provides the **deduction of loss in calculating the person's income from business or investment.** Two types of losses may be incurred in the context of business or investment.

i. The loss on the disposal of an asset or liability of a business or investment.

ii. Overall loss of a business or investment.

With respect of first type of loss, treatment on disposal will depend on the type of asset in question. That is, if asset in question is either trading stock or depreciable assets or capital assets of a business, loss of disposal falls within the second type of business.

Loss deduction rules.

1.

(a) An unrelieved loss of the person for the year from a business can be deducted from any other business of that person.

(b) An unrelieved loss of the person for any of the previous six years of assessment from the business or any other business.

As per section 19(6)

"loss" of a person for a year of assessment from a business or investment shall be calculated as the excess of amounts deducted **in accordance with this Act** (other than under this section or subsection (5) of section 25) in calculating the person's income from the business or investment over amounts included in calculating that income; and

"unrelieved loss" means the amount of a loss that has not been deducted in calculating a person's income under this section or subsection (5) of section 25.

Accordingly, only the loss calculated under the Act, No. 24 of 2017 can be deducted under section 19. That means a transitional provision need to be incorporated to the Act to treat the brought forward loss under the Inland Revenue Act, No.10 of 2006.

2. An unrelieved loss which is eligible to deduct for a Year of Assessment cannot be deferred to another year of Assessment.
3. Reduced rate loss can be deducted only from same reduced rate or lower reduced rate or exempt profit.
4. The above deduction rules apply on treatment of investment losses other than the losses from disposal of investment assets.

   (a) An unrelieved loss from a business may be deducted in calculating the income from business.

   (b) An unrelieved loss from investment can be deducted only in calculating the income from investment.

6. Gain from realization of an investment asset shall not be deducted by any loss on the disposal of another investment asset.

4.11 Other deductions in the Act

1. A Person other than a person conducting banking business can write-off debt claim as bad debt if such person has taken reasonable steps to recovery and the person reasonably believe that recovery is not possible (S.24).
2. A person conducting banking business can make specific provision for bad debt as per the directives made by Central Bank of Sri Lanka and but deductible amount from such provision will be specified by the Commissioner General (s.66).
3. A non-resident person carrying on business in Sri Lanka through a Sri Lankan permanent establishment can deduct head office expense not exceeding 10% of person's assessable income. Where such expense is exceeding 10% of person's assessable income, no deduction is available (S.79).

Chapter 5 - Capital allowances and balancing allowances

5.1 Relevant provisions

Section 16 permits a deduction for the capital allowances and balancing allowances granted under the Second or Fourth Schedule in calculating a person's income from a business.

When calculating a person's income from a business for a year of assessment;

(a) the capital allowances; and
(b) the balancing allowances,

shall be deducted;

5.2 Capital allowances

A person is entitled to claim capital allowances if such person;

(i) Is the **owner** of the depreciable asset; and
(ii) **Uses** them **at the end of a year of assessment** in the **production of the person's income** from **a business**;
(iii) If the asset is **partly used** in the production of income from a business, the cost and consideration received for the asset shall be **apportioned** according to the market value of that part of the asset that is used in the production of income from that business. Please refer No.02 fourth schedule of the Act

As defined in section 195

"depreciable asset"

(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;

Capital allowances –

- for each depreciable asset shall be calculated according to the straight-line method
- are calculated in accordance with the provisions of the Second or Fourth Schedule to the Act.
- which are granted with respect to a particular year of assessment shall be taken in that year and **shall not be deferred** to a later year of assessment.
- shall not be granted to a person in respect of a road vehicles, other than –
    (a) a commercial vehicle ("commercial vehicle" means a road vehicle designed to carry loads of more than half a tonne or more than 13 passengers; or a vehicle used in a transportation or vehicle rental business.)
    (b) bus or minibus;
    (c) a goods vehicle; or
    (d) a heavy general purpose or specialised truck or trailer;

even though the road vehicles are fallen within the depreciable asset. (Please refer No 4 of fourth schedule)

5.3 Calculation of capital allowance

Formula for Calculating capital allowance

A/B

A - the depreciation basis of asset at the end of the year of assessment
B - number of years (please see table 01 which is provided in the item (3) of Fourth Schedule)

Depreciation basis is the sum of –

(a) the 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 including the excess expense of repair and improvements referred to in section 14 for which a deduction shall not be allowed as a result of the limitation.

For the purpose of calculating the capital allowances, the depreciable assets which have been distinguished between 5 classes of assets and the number of years applicable to relevant depreciable asset which have been stated in Fourth Schedule, have been incorporated for the easy reference as follows.

Table 1

Class	Depreciable Assets	Number of Years
1	computers and data handling equipment together with peripheral devices	5
2	buses and minibuses, goods vehicles; construction and earthmoving equipment, heavy general purpose or specialized trucks, trailers and trailer-mounted containers; plant and machinery used in manufacturing	5
3	railroad cars, locomotives, and equipment; vessels, barges, tugs, and similar water transportation equipment; aircraft; specialized public utility plant, equipment, and machinery; office furniture, fixtures, and equipment; any depreciable asset not included in another class	5

4	buildings, structures and similar works of a permanent nature	20
5	intangible assets, excluding goodwill	The actual useful life of the intangible asset, or where the intangible asset has an indefinite useful life, 20.

5.4 Balancing allowances

Balancing allowances are –

(a) made in respect of depreciable assets
   i. realized during a year of assessment; and
   ii. in respect of which depreciation allowances have been granted in that year or an earlier year; and
(b) calculated in accordance with the provisions of the Second or Fourth Schedule to this Act.

5.5 Basic Concepts

i. Identification of the income source

Capital allowances are granted in the production of the person's income from a business. Therefore**,** it is necessary to determine first whether the taxpayer is conducting a business or an investment.

In order to classify an asset properly, identifying the source of income may have an impact on not only how the asset is classified but also how the asset is identified.

Scenario 1

Mr A, acquires an office building with the land. He engages a property manager to rent out the offices in return for 7% of the gross rent received. assuming this is Mr A's only office building, there is no repetition and he is not actively engaged with the property, he has engaged a manager. Hence his activities do not fall within the definition of "business" in s. 195; there is no "trade". Mr A intends to hold the property, which will produce an income of itself through the rent. His activities clearly fall within the definition of "investment" in s. 195. At the end of the year of assessment Mr. A must calculates his income from the investment under s. 7.

Scenario 2

Mr A owned and rented out 5 office buildings and managed the properties himself. Here the repetition and active engagement of Mr A with the properties would be sufficient to constitute a business of property rental. So, at the end of the year of assessment Mr A must calculate his income from the business under s. 6.

Since Mr. A is conducting an investment the land and building owned by Mr A would be considered a single asset. An asset can only be a depreciable asset to the extent that it is used in the production of income from a *business*, therefore this office is not a depreciable asset.

In the 2nd scenario, Mr A is conducting a business. Here the offices are used in the production of income from the rental business, i.e. the rent, which is not a final withholding payment under s. 88(1)(c). The building is therefore a depreciable asset and must be classified under class 4 assets. Accordingly, the office building will fall into Class 4 and such buildings must be separate from the other buildings of Mr A's business.

A separation will only be required of the land and building if the building is a "depreciable asset" under s. 195. the land is not a depreciable asset as defined. But, as it is used in the business, the land will be a "capital asset", under s. 195. So despite typically constituting a single asset, the Act requires a separation of the land and the building for tax purposes.

5.6 Classifying the depreciable Asset

The classes of asset mentioned in the above **table 1** [paragraph 1(1) of the Fourth Schedule] are very broad and therefore it will be difficult to identify the relevant class which an asset belongs to. In such cases, a two-step analysis should be made in classifying the asset.

(i) consider the wording of the various classes outlined in the above Table 1 and determine on a fair reading which class the asset falls into.

(ii) if it is still not clear, determine number of years applicable to a depreciable asset mentioned in Table 1 (paragraph 2(3) of the Fourth Schedule) based on the useful life of the asset and the useful life of similar assets that do clearly fall within a particular class, which the asset most fairly belongs in.

If the analysis is still unclear, then the asset falls into the residual category of "any depreciable asset not included in another Class", i.e. Class 3.

Example 5.6.1

Company A runs a business that involves the application of plastics and other chemical compounds to various solid surfaces. It recently had a special "room" installed in part of its factory. The plastics are applied to solid surfaces in the "room" under heavily controlled conditions as to moisture and temperature and to keep contaminates out.

The "room" incorporates various fans, elements and computer controls in order to control the environment in the "room". The "room" may be easily relocated between different parts of the factory but once in place it is loosely fixed to the floor.

In determining which class of depreciable asset, the "room" belongs to, Company A should follow the steps mentioned above.

The "room" possibly falls to be classified as a "structure" under Class 4, a "fixture" under Class 3 or “any depreciable asset not included in another class” under Class 3.

As the wording does not provide a clear answer to this classification, Company A should consider the number of years which have been incorporated to above Table 1, the useful life of the asset and make an analogy with similar types of assets. With daily use, the "room" is expected to have a useful life of 20 years. By this time the fan and other control devices should be worn out and the computing system obsolete. The frame of the room may still be useable but it would be more cost efficient to replace the entire "room" at this stage rather than try to replace constituent parts. The analysis makes it clear that the number of years provided for Class 4 assets is inappropriate.

Further, the analysis makes it clear that while the "room" may be a "structure" it is not a structure "of a permanent nature" in a way consistent with the number of years provided and the useful life of other assets likely to fall within Class 4.

Company A's "room" is effectively an item of plant or machinery with and through which Company A conducts its business. It correctly falls for classification residually as a Class 3 asset.

If it is uncertain about the proper classification of a particular asset a private ruling can be applied under s. 107

5.7 Special Case

i. Capital allowance for a depreciable asset which is received as a gift

If a depreciable asset is received as a gift in respect of a business the asset will have a cost equal to the amount included in income by reason of s. 6(2)(f), this amount will be included to the relevant class of depreciable assets and capital allowances can be granted.

ii. Capital allowances for an asset that is in temporary disuse.

With respect to granting capital allowances, the asset must be “owned and used” by the person during the year. It is rare that a person does not use the depreciable asset at any time during a year unless it is in need of repair or has become obsolete. It can be considered that assets in need of repair continue to be treated as depreciable assets and used in the business until the asset has truly become obsolete and the person disposes of it because repair of assets is a natural part of a business.

Example 5.7.1

One of the printing machines of Company A is broken down and the Company has had substantial problem of getting it repaired because they had to order parts from the European manufacturer. Hence the Company A had to wait 14 months. Despite the 14 months during which the printing machine was not in use, Company A was actively pursuing its repair

and did succeed in having the machine put back into operation. Company A may continue to claim capital allowances during the time it took to have the printing machine repaired.

Example 5.7.2

One of the plant of Company B is also broken down. It could still be used for minor jobs but Company B effectively discarded it when it bought a new plant as a replacement. At this point Company B put the old plant outside its factory under a loose cover. Within a year the old plant deteriorated to such an extent that it could not be used at all. In the course of a general clean up, Company B later dumped the plant at a landfill site. From a tax perspective, at the point Company B discarded the plant and put it outside Company B is treated as having disposed of the plant under s. 39(e).

04.01.2019 Plant broken down - 2018/2019 can claim capital allowance
06.07.2019 Bought a new machine and machine A discarded – 2019/2020 not entitled to claim capital allowances
10.04.2020 Dumped the plant – 2020/2021 not entitled to claim capital allowances

iii. Capital allowance for Tangible Assets that take some years to construct or grow

Another area worthy of consideration is the treatment of depreciable assets that take some years to construct or grow. the cost of the asset will only be added to the relevant class of depreciable assets once it is "used" in the production of income. So, until the assets are placed in active production, no capital allowance can be claimed.

Example 5.7.3

Company A acquired land and incurred substantial costs planting it with tea. The tea plants will not come into production for 3 to 4 years and they have a limited useful life, typically about 50 years. The tea plants constitute depreciable assets for tax purposes under s. 195.

Accordingly;

i. Overhead costs that are not directly attributable to bringing the plants to maturity would be deductible under general principles.

ii. costs that are related to bringing the plants to maturity, such as fertilizer, water and the wages of persons tending the plants, must be capitalized in the cost of the plants and so no deduction is available.

iii. Amounts that are not immediately deductible will be included to the cost of the tea plants for tax purposes according to s. 37(1).

iv. When the plants are put into production then these amounts can be categorized under Company A's Class 3 of depreciable assets and capital allowance can be granted.

Example 5.7.4

Company A runs a hotel. It commissioned Company Z to construct a new hotel in Colombo. The contract price is Rs. 20,000,000 and the construction period is two and a half years.

Company A is required to pay the contract price in instalments as follows,

- deposit	-	10%,
- after the foundations are laid	-	20%
- after lock-up	-	40%
- on completion	-	30%.

It may not claim capital allowances in respect of the hotel until the hotel is constructed and put into use, s. 16. Once the hotel is opened, Company A may categorize the contract price to the Class 4 depreciable assets and claim capital allowances accordingly.

5.8 Capital allowances for Intangible Assets

In granting capital allowances, the Act takes a different approach to intangible assets than it does with respect to tangible assets. Each intangible asset is placed in class 5 and the depreciation period applied to an intangible asset is a function of its actual useful life.

Example 5.8.1

Mr R wishes to rent a number of offices from Company P.

The lease period is	=	3 years
05.08.2018 Premium paid for entering in to lease	=	Rs. 300,000

The definition of "rent" in s. 195 includes the receipt of a premium. So, the whole Rs. 300,000 is treated as rent derived by Company P during Y/A 2018/2019.

The treatment of the payment of the premium by Mr R is more complex. Periodic rent paid under a lease will typically be deductible under s. 11 in the year in which it is incurred. However, this will not be the case if the rent is of a capital nature as defined in s.11(3).

The lease would be an intangible asset of Mr R and as such it falls within the definition of "asset" in s. 195. So, the premium is an expense incurred in the acquisition of an asset with a useful life exceeding 12 months, therefore, is capital in nature and not deductible, s. 11(3).

The lease will also be a depreciable asset of Mr R, s. 195. In particular, it is a Class 5 depreciable asset. So at the end of Y/A 2018/2019 Mr R will be able to claim depreciation in respect of the lease, s. 16.

In order to calculate the depreciation under the Fourth Schedule the first matter is to calculate the depreciation basis for the lease at the end of the Y/A as per Fourth Schedule paragraph 3(2), which is Rs. 300,000. The useful life of an intangible asset is used in working out the rate of depreciation applicable to it. In this case the actual useful life of

the lease is 3 years, giving depreciation for Y/A 2018/2019 of Rs. 100,000. Mr R will be entitled to a similar amount of depreciation in Years of assessments 2019/2020 and 2020/2021

Paid premium on 05.08.2018	=	Rs. 300,000
Lease period =actual useful life	=	3 years
Capital allowance for y/A 2018/2019	=	300,000/3 = 100,000

1. Excess repair expenses which a deduction is not allowed to be added to the depreciation basis.

According to section 14(2) the deduction for repairs and improvements, for assets categorized under class 4 is limited to 5% and for all other cases 20% of the WDV of the asset at the end of previous year. Excess expense for which a deduction is not allowed shall be added to the depreciation basis of the asset year (paragraph (3) of the Fourth Schedule).

Company P runs a manufacturing business.
During Y/A 2018/2019 it incurs expenditure as follows:

- 05.09.2018 : Rs. 700,000 on repairs and improvements to machine A
- 08.12.2018 : Rs. 1,800,000 in buying machine B
- 04.03.2019 : Rs. 200,000 on repairs and improvements to machine B
- 15.07.2019 : Rs. 400,000 on repairs and improvements to machine A
- 13.08.2021 : Rs. 150,000 on repairs and improvements to machine A

Assume the WDV of the machine A (bought on 06.07.2017) at the end of the Y/A 2017/2018 was Rs. 2,000,000.

Machine A
Repair expenses incurred on the Y/A 2018/2019

WDV of the machine A at the end of Y/A 2017/2018=		Rs. 2,000,000
Allowable deduction for repair & improvements	=	2,000,000*20%
Allowable expense	=	Rs. 400,000
Expenses incurred	=	Rs. 700,000
Expenses not allowed (add to the depreciation basis)	=	Rs. 300,000

In addition to the deduction for repairs and improvements, Company A will wish to claim depreciation of its machine A.

As these machines have already been classified under class 3, capital allowance for machine A is;

Machine A

2018/2019

Machine A		=	Rs. 2,000,000 (WDV)
Add:	Repair cost	=	Rs. 300,000
			Rs. 2,300,000
	Capital allowance	=	2,300,000/4
		=	575,000

Or

2018/2019

Machine A		=	Rs. 2,000,000
Add:	Repair cost	=	Rs. 300,000
			Rs. 2,000,000
	Capital allowance	=	2,000,000/4
		=	500,000

Repair expenses incurred on the Y/A 2019/2020

WDV of the machine A at the end of Y/A 2018/2019	=	Rs. 1,500,000
Allowable deduction for repair & improvements	=	1,500,000*20%
Allowable expense	=	Rs. 300,000
Expenses incurred	=	Rs. 400,000
Expenses not allowed (add to the depreciation basis)	=	Rs. 100,000

2019/2020

Machine A		=	Rs. 1500,000 (2,000,000-500,000)
Add:	Repair cost	=	Rs. 300,000
			Rs. 1,800,000
	Capital allowance	=	1,800,000/3
		=	600,000

Machine B

WDV of the machine B at the end of Y/A 2017/2018	=	Nil
Allowable deduction for repair & improvements	=	Nil
Expenses incurred	=	Rs. 200,000
Expenses not allowed (add to the depreciation basis)	=	Rs. 200,000

New Machine

2018/2019		=	Rs. 1,800,000/5
		=	Rs. 360,000
2019/2020		=	Rs. 1,440,000
	Repair cost	=	Rs. 200,000
		=	Rs. 1,240,000/4
		=	Rs. 310,000

2. Claiming capital allowance on repair expenses incurred by a lessee.

This has been taken from the old manual. Later the position was changed and as per section 49(2) where an asset is leased under a finance lease, the lessor shall be treated as transferring ownership of the asset to the lessee. Accordingly, capital allowances are claimable by lessee and not the lessor

Under the terms of the lease, asset is owned by the lessor. If the lessor is engaging in a business, the asset used for the business is a depreciable asset of the lessor. Hence lessor is entitled to claim capital allowances. Sec 14 is applicable only to the depreciable assets. Since the lessee is not entitled to claim capital allowance, s. 14(2) limitation does not apply. In such a case s. 11 will apply. Hence the lessee is entitled to deduct the full costs of the repairs in the same way as the lessee would be entitled to deduct the full amount of rent paid to the lessor.

Example 5.8.2

> Mr A leases a shop from Mr Z under a 5-year lease. Under the terms of the lease Mr A is obliged to pay Rs. 100,000 per month by way of rent. In addition, Mr A is obliged to make all necessary repairs to maintain the premises in good order and condition. During the Y/A 2018/2019 Mr A spends Rs. 150,000 on repairs, essentially some plumbing and electrical work and repainting the window front. Mr A may deduct both the cost of rent paid as well as the repair costs under s. 11. Section 14 has no application because Mr A does not own the premises.

i. Claiming capital allowance on repair expenses incurred by a lessor

The lessor will charge a certain amount of rent but be obliged to incur costs in making any necessary repairs. These repairs would be deductible to the lessor subject to the limitation in s. 14. The excess repair cost which is not allowed as a deduction due to such limitation could be added to the depreciation basis of the asset and entitled to claim capital allowance.

ii. Claiming capital allowances by lessee on improvements made by lessee.

Conceptually, repairs do not improve the value of an asset but only maintain it. By contrast, improvements enhance the value of an asset. As well improvements produce the benefit for lessee and the cost will last longer than 12 months. Accordingly, such cost will be capital nature, hence not deductible under section 11. But the expense will constitute an intangible asset of the lessee for which capital allowances may be claimed over the term of the lease.

Example 5.8.3

> Mr P enters in to a lease for 3 years with company S and under the terms of the lease, Mr P is obliged to not only make repairs but also to install a modern brick storage facility during the first year of the lease. Mr P incurs the rent and repairs. In addition, Mr P incurs Rs. 420,000 in installing the new storage facility.

Improvement cost	Rs. 420,000
Lease period	3 years
Capital allowance for a year	400,000/3 = 140,000

iii. Claiming capital allowances by lessor on improvements made by lessee.

Improvements should be considered as a payment of rent and taxable to the lessor. In such a case, it is appropriate to treat the amount taxable in respect of the improvement as falling into the cost base of the asset in question. This would enable the lessor to claim depreciation allowances in respect of the improvement (amount included in income).

Example 5.8.4

According to the above example cost of improvements of Rs. 420,000 made by Mr. P (Lessee) is considered as a payment of rent to Mr. S (lessor). Hence taxable to Mr. S (the lessor.)

5.9 The circumstances of including assessable charges or granting balancing allowances

Where a depreciable asset of a person is realized, when calculating the person's income;

(a) an assessable charge is included or
(b) a balancing allowance is granted

The realization of depreciable assets is dealt with in Fourth Schedule paragraph 4. Where the depreciable asset is realized, the simple rule is that the amounts derived on realization of end of the year in which the disposal takes place.

Charge or allowance is calculated in accordance with the following formula.

(a) Calculation of an assessable charge (profit)

consideration received - written down value of the asset at the time of realization of the asset

If the amount received on realization of a depreciable asset exceeds the written down value of the asset at the time of realization, such amount will be required to include an amount in their income,

Example 5.9.1

Company A runs a property rental business and owns a building of apartments for rental. At the start of year 1, the balance in Company A's class 4 is Rs. 30,000,000, i.e. the balance at the end of the previous year less the depreciation allowance granted for that year. Company A is expecting to sell off a large number of the apartments in the building except for a few select apartments. As a result, during year 1 it receives Rs. 50,000,000 as proceeds from the sales.

Consideration received from the realization of apartments during the year - Rs. 50,000,000

Less: written down value at the end of the year of assessment - Rs. 30,000,000

The amount to be included in calculating its income for year 1 - Rs. 20,000,000

(b) Calculation of balancing allowance (Loss)

written down value of the asset at the time of realization of the asset- consideration received

If the written down value exceeds the amount received on realization, the excess is allowed as a deduction in calculating the person's business income.

Example 5.9.2

Company R sells office furniture at the price of Rs. 700,000 and at the time of disposal the written down value of the asset is Rs. 1,000,000.

With respect to the office furniture, Company R will be granted a deduction in the amount by which the written down value of the asset exceeds the proceeds of sale, i.e. Rs. 300,000.

Sale proceed	=	Rs. 700,000
WDV	=	Rs. 1,000,000
Balancing allowance (Loss)	=	Rs. 300,000

Rs. 300,000 is allowed as a deduction when calculating company R's business income

"written down value of an asset at the time of realization of the asset" means; the expenses incurred by a person in acquiring the asset reduced by all depreciation allowances granted to the person under paragraph 2 in respect of the asset.

5.9.1 Enhanced Depreciation Allowances – Second Schedule

A person who invests in Sri Lanka (other than the expansion of an existing business) during a year of assessment shall be granted enhanced capital allowances, in addition to the capital allowances computed under the Fourth Schedule.

1. Enhanced capital allowances shall be granted to the person for the year if the total expenses incurred by that person during that year on depreciable assets (other than intangible assets) as follows;

Criteria	Limitation	Percentage of capital allowance
1. Depreciable assets used in a part of Sri Lanka other than the Northern Province	exceeds USD 3 million but does not exceed USD 100 million	100%
2. Depreciable assets used in a part of Sri Lanka other than the Northern Province	exceeds USD 100 million	150%
3. Depreciable assets used in the Northern Province	exceeds USD 3 million	200%
4. Depreciable assets of state-owned company that are used in a part of Sri Lanka	exceeds USD 250 million	150%

2. Depreciation allowances arising above one paragraph of above table with respect to a particular year of assessment cannot be accumulated with another paragraph and shall be taken in that year and shall be deferred to a later year of assessment.

Chapter 6 - Investment Income

6.1 What is Investment Income?

Investment income is defined in the Act as follows;

"Investment" means –

(a) 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

i. Includes a past, present or prospective investment; but

ii. Excludes a business or employment; or

(b) A game of chance, including lotteries, betting or gambling;

Accordingly, Investment involves holding assets (except for an asset being the principal place of residence of residence an individual, subject to conditions) passively for gain. As per the concept of dominancy over sources of income, it excludes the business or employment.

Section 7 defines the types of investment income. Accordingly, in calculating person's gains and profit from an investment, following amounts received or derived by the person during the year of assessment shall be included.

(a) dividends, interest, discounts, charges, annuities, natural resource payments, rents, premiums and royalties;

(b) gains from the realisation of investment assets as calculated under Chapter IV;

(c) amounts derived as consideration for accepting a restriction on the capacity to conduct the investment;

(d) gifts received by the person in respect of the investment;

(e) winnings from lotteries, betting or gambling; and

(f) Other amounts required to be included under this Act.

It is noted here many of the types of the income mentioned above as investment income may also be derived in the context of business. The effective connection with the type of activity determines whether amount is from business or investment. The "effectively connected" test is a question of nexus or association. So, if an amount is derived in the context of business, it is treated as business income irrespective of whether it is mentioned in section 7. For example, interest income is definitely being a business income for a bank even if it is mentioned in section 7. Further, if an exporting company deposit its additional funds in a 5-year fixed deposit plan with a bank will amount to an investment. However, interest income earned by such company from the money kept in a bank to get export guarantees amounts to a business receipt as it is effectively connected to the business.

In this regard, IRD will continue to apply the approach of the court of Appeal in *Ceylon steel corporation limited vs Commissioner General of Inland Revenue.* Further, with amounts other than

the interest (why), it is acceptable principles of generally acceptable accounting standards in classification of income items.

The Consequences attached with the decision whether an amount constitutes income from a business or income from an investment.

1. **Deduction of Expenses**

   Applicability of deduction rules on expenses depends on whether the relevant amount constitutes income from a business or income from an investment.

   Accordingly, following sections are not applicable in calculating the person's income from investment.

   i. Section 13 - Allowance for trading stock
   ii. Section 14 - Repairs and improvements
   iii. Section 15 - Research and development expenses and Agricultural start-up expenses
   iv. Section 16 - Capital Allowance and balancing allowance
   v. Section 17 - Losses on realisation of business assets and Liabilities

2. **Deduction of unrelieved losses under section 19**

   The classification of a revenue receipt either to a business or an investment is required to apply rules of deduction unrelieved losses under section 19.

   Such applicable rules are as follows;

   i. Unrelieved losses from business **may be** deducted in calculating income from an investment.
   ii. Unrelieved losses from an investment **shall be** deducted **only** in calculating income from an investment.

3. **Method of Accounting**

   The requirement of the Act to keep accounts for income tax purposes under section 21 depends on whether an individual or entity conducting a business or having an investment.

   Accordingly, the section has set out following requirements;

   i. An individual shall account for income tax purposes on a **cash basis** in calculating the **individual's** income from **investment**.

   ii. An entity shall account for income tax purposes **either on a cash basis or accrual basis** whichever properly computes the **entity's** income from **investment.**

iii. An **individual or entity** conducting **business** shall account for income tax purposes on **an accrual basis**.

4. Deduction of qualifying relief under section 52.

An **individual** who receives **rental income** from an investment asset, that means who receives rental income as a receipt from **an investment** only and not as a business receipt can claim **qualifying relief** referred to in section 52.

Investment and Investment Asset

As per the definitions given for "investment" and "investment asset "in section 195, owning of any kind of asset (not only investment assets) amounts to be an investment. However, to be treated as an investment asset, a capital asset, subject to the exclusion in the definition,

6.2 Investment receipts

6.2.1 Rent

"*Rent"* –

(a) means a payment, including a payment of a premium or like amount, for the use of or right to use 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 in paragraph (a); but
(c) excludes a natural resource payment or a royalty;

A person may lease a tangible asset in return for rent. The activity of the person in leasing the asset may or may not amount to a business, where it does not, the rent must be included in calculating the person's income from their investment,

Example 6.2.1.1

Mr. Aruna acquires an office building (and land) in 1st year for Rs. 30 million. Mr Aruna holds the building as an "investment" (defined in s. 195). Therefore, at the end of 1st year Mr. Aruna must calculate his income from the investment and (assuming that all the facts occur within Sri Lanka) this will also be Mr. Aruna 's assessable income from the investment under s. 7. Mr. Aruna 's assessable income from the investment must be included in calculating his taxable income under s. 3.

Income from an investment is calculated under s. 7(1) as the profits and gains from conducting the investment. So, in principle, any rent received from the property is included in calculating those profits and gains, s. 7(2)(a). Withholding is required of the tenant under s. 84(1) (it is not excluded by s. 84(2)(a) unless the tenant is an individual who is not conducting a business from the rented office). Therefore, rent is subject to 10% withholding

under First Schedule paragraph 8 but it is not final. Mr Aruna is able to claim this WHT as a credit from his final tax liability s.89.

Mr Aruna incurs expenditure in the form of commission for the services of the property manager. This payment of commission is deductible for Mr Aruna as it is incurred in deriving the rent.

Mr Aruna cannot deduct the expenditure on the acquisition of the building because it is of a capital nature, s. 11(2). In particular, ps. 11(3) states that expenses are of a capital nature if incurred in securing a benefit lasting longer than 12 months, which would include acquiring an asset with a useful life exceeding 12 months. The building is an asset (as per definition in s. 195) and would have a useful life exceeding 12 months. While the acquisition cost of the building is not deductible, it is a cost incurred with respect to the building under s. 37(1)(a). The land and building will be considered a single asset, and not a depreciable asset, so Mr Aruna is also not entitled to any deductions for repairs and improvements to the building (s. 14) or for depreciation of the building (s. 16). However, the benefit of repairs not lasting longer than 12 months is deductible under s.11.

If Mr Aruna does not claim above repair expenses under section 11he will be able to claim individual relief under fifth schedule

"in the case of an individual with rental income from an investment asset, an amount equal to 25 percent of the total rental income for the year of assessment, being a relief for the repair, maintenance, and depreciation relating to the investment asset, but shall only be allowed to the extent no deduction or cost is claimed for any actual expenditures incurred by the taxpayer for the repair, maintenance, and depreciation of the investment asset;"

6.2.2 Royalties

***"royalty**" means a payment, including a payment of a premium or like amount, derived*

as 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;

(b) the use of or right to use a patent, trade mark, design or model, plan, or secret formula or process;

(c) the use of or right to use any industrial, commercial, or scientific equipment;

(d) the use of or right to use information concerning industrial, commercial, or scientific experience;

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

(f) a total or partial forbearance with respect to a matter referred to in paragraph (a), (b), (c), (d) or (e);

As discussed previously, the definition of "royalty" in s. 195 is predominately a payment for the use of intangible property. The specific inclusions in the definition are largely examples of this general approach but there are extensions, e.g. in the form of payments for the supply of know-how, ancillary payments and forbearance payments.

Example 6.2.2.1

PQR Sri Lanka Ltd manufacturer of the product A and is the patent owner for that product. During the year 2018/2019 the Company sells a temporary license to use its patent in Bangladesh to Dhaka Industries for a price of Rs. 1 million and 5% of gross profits from its use. The Company receives Rs. 500,000 from Dhaka Industries under the 5% clause. The money paid for the Bangladesh license is a payment for the use of a patent and therefore falls within the meaning of paragraph (b) of the definition of "royalty" in s. 195(2).

Though the result of Rs. 1.5 million is an amount that can be included under s. 7(3)(a), but, because the amount is effectively connected with the Company's business, Company must include the amount in calculating its income from the business - s. 6(3)(g).

The royalties received are for the use of an asset in Bangladesh and so they will have a foreign source, s. 73(1)(c) and (2). Therefore, if Bangladesh taxes the royalties, the Company may be allowed a foreign tax credit for that tax under s. 80.

6.2.3 Natural resource Payments

“Natural resource” means minerals, petroleum, water or any other non-living or living resource that may be taken from land or the sea;

“natural resource payment” means a payment, including a premium or like amount, for the right to take natural resources from land or the sea or calculated in whole or part by reference to the quantity or value of natural resources taken from land or the sea;

According to the definition natural resource payments are excluded from the definitions of "rent" and "royalty", i.e. if a payment is a natural resource payment it is neither rent nor royalty. The definition of "natural resource payment" has two branches. The first branch focuses on the "right to take" resources "from land or the sea". Such resources could be living or non-living, so the definition includes the removal of living resources such as trees, crops and fish. It also includes non-living resources such as water, minerals, soil or oil. The resource must be taken from the land or the sea and so resources that live above the land, like most animals, are not included unless they are attached to the land, as in the case of trees and crops. Further, it is only payments for the "right to take" the resources that are covered. So, for example, a payment for the right to enter a property, cut down and take away trees is a natural resource payment, but a payment for trees that have already been cut down is not.

The second branch of the definition of "natural resource payment" in s. 195 covers indirect payments of the type covered by the first limb. It covers payments that are calculated according to the amount of natural resources to be taken from the land or the sea.

Example 6.2.3.1

Mr Kasun owns an agricultural land which believes include certain minerals. Company ABC is a mining company. In year 1 it pays Mr Kasun LKR 1 million for the right to enter his property and test for the existence of this minerals. In year 2 Company ABC discovers substantial quantities of various minerals and signs a 5-year agreement under which it agrees to pay Mr Kasun what is described as a "royalty" of 5% of the value of minerals extracted. Extraction begins in year 3 and during that year Company ABC pays Mr Kasun "royalties" of LKR 2 million under the agreement.

The payment received in year 1 is not a "natural resource payment" in s. 195 because it is not for taking resources from Mr Kasun's land but for the right to enter the land. Any right to take minerals would be merely supplementary to the main right of entry. The right of entry would be a licence and so be a "lease" as defined in s. 195. As the LKR 1 million is a payment made under this "lease", it is "rent" as defined in s. 195. It is clear that the receipt of this rent is not "effectively connected" with Mr Kasun's agricultural business for the purposes of s. 6(3)(g). Rather, the rent will be received with respect to the "investment" of Mr Kasun in holding his property. While this property will generally be considered a business asset in the context of Mr Kasun's agricultural business, it is only such an asset to the extent to which it is used in the business. The granting of the right of Company ABC to enter the land does not involve the "use" of the land in the context of Mr Kasun's agricultural business. To this extent, the holding of the land by Mr Kasun constitutes an investment. The LKR 1 million received from Company ABC constitutes rent from this investment and must be included in calculating his income from this investment, s. 7(2)(a). The "royalties" received by him in year 3 do constitute a "natural resource payment" under s. 195 and so are not a "royalty" for tax purposes. As with the payment received in year 1, the payment received in year 3 will be received in the context of Mr Kasun's investment in his property. So, he must include the LKR 2 million in calculating his income from the investment in year 3.
Company ABC required to deduct 10% WHT from 1M Rent and 14% from 2M natural resource payment and Mr Kasun is able to claim this WHT as a credit from his final tax liability s.89.

6.2.4 Dividend

"Dividend" is defined in s. 195(1) very broadly in terms of a payment derived by a member from a company, paragraph (a) of the definition of "dividend" in s. 195(1). The concept of "payment" imports a broad meaning as defined in s. 195(1) and so the concept of "dividend" covers all types of in-kind payments and constructive distributions. Also included in the concept of "dividend" is a capitalization of profits by a company, whether by way of a bonus share issue, increase in the amount paid-up on shares or otherwise, and regardless of whether such amount is distributed or not.

However, the amount of "dividend" is reduced by any 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, paragraph (c) of definition of "dividend" in s.195(1).

Definition of a "Dividend"

(a) 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;

(b) includes a capitalization of profits –

i. whether by way of a bonus share issue, increase in the amount paid-up on shares or otherwise; and

ii. whether an amount is distributed or not; and

(c) excludes a payment to the extent to which it is –

i. matched by a payment made by the member to the company;

ii. debited to a capital, share premium or similar account; or

iii. otherwise constitutes a final withholding payment or is included in calculating the income of the member;

Dividend distribute by way of Bonus share: When a company issues bonus shares the existing shareholders in the company receive extra shares. The company pays up the par or nominal value of the shares (and any premium) by transferring an amount from the company's retained profits to the company's share capital account. But no money changes indicators when a company issues bonus shares and so an issue of bonus shares does not result in a reduction in the value of the company. Nevertheless, the issue of bonus shares as capitalization of profits is specifically treated as a dividend regardless of whether an amount is distributed or not, paragraph (b) of definition of "dividend" in s. 195(1)) and so results in a dividend equal to the paid up value of the bonus shares. When paid by a resident company, this amount may constitute a final withholding payment and subject to a 14% withholding tax, ss. 61(1)(a), 88(1)(a) and First Schedule. When paid by a non-resident company, this amount must be included in calculating the income of the shareholders, s. 61(1)(b).

However, the issue of bonus shares potentially causes a reduction in the value of the existing shares. In this situation, in order for the final withholding payment to qualify as a cost, then it is requiring that those costs and the costs for the existing shares are spread evenly across the bonus shares and the existing shares. If the bonus shares are of a different class to the original shares, the spreading must be proportionate to the market values of the different classes.

Example 6.2.4.1

Mr. A owns 100 shares in Company Z, a resident company. Mr. A paid Rs. 500 per share for the shares. Company Z capitalizes profits and Mr. A receives in respect of his shareholding a further 20 shares with a paid-up value of Rs. 300 per share. Company Z is treated as distributing a dividend equal to the capitalized amount of the bonus shares, i.e. Rs. 300 per share and will be liable to account for final withholding tax at the rate of 14% on this amount. Mr. A has costs with respect to his existing shareholding of Rs. 500 per share. Mr. A has costs of a further Rs. 300 per bonus share but requires Mr. A to spread this amount and the costs of the existing shareholding evenly across the entire shareholding after the issue of the bonus shares. In order to do this, Mr. A must calculate his costs of his entire shareholding. This amounts to Rs. 56,000 {(100 x500=Rs. 50,000) +(20 x 300 = Rs. 6,000). Mr. A must divide this amount by the number of shares he now holds, i.e. 120. This gives adjusted cost of Rs. 467 per share. Therefore, if Mr. A subsequently sells 10 shares for Rs. 5,500 he will realize a gain on disposal of Rs. 830 (Rs. 5,500 less Rs. 4,670) irrespective of whether Mr. A sells part of his original shareholding or part of his bonus shareholding.

6.2.5 Interest

"interest" includes –

(a) a payment, including of a discount or premium, made under a debt obligation that is not a return of capital;

(b) a swap or other payment functionally equivalent to interest;

- *Interest to be assed is income derived from investment, loans, charges on unpaid debts, and court awards etc.*
- *interest income is a part of an investment income.*
- *The surplus received by a person for the money deposited in a bank or financial institution is interest.*
- *The additional amount received by a person who lends money is an interest. If any charge is not settled within specific time period, the additional amount to be charged and that is also an interest.*
- *Unpaid debt also increases by an additional amount and that also identified as interest.*

6.2.6 Other receipts

Discount - Income from discounts means the gains derived from the casual discounting of bills of exchanges etc. Gains arising from the discounting of bills of exchange, cheques, etc. in the normal course of business considered as business income.

Charges - A charge is a sum received by a person under deed or an order of court which is secured on the income or property of payer.

Annuities - An annuity is 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 instalment.

Example - Receipt of monthly payment after contributing of pension fund

Premiums - are payments received as a consideration for obtaining the right to use a property rather than for the actual use of the property.
Example- Receipt of key money on letting a premise

6.2.7 Gift Received on Investment

"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.

6.2.8 Winnings from lotteries

Winnings from lotteries, betting or gambling are specifically deemed to be income from an investment, s. 7(3)(e). However, no deduction is allowed for amounts incurred on lotteries, betting or gambling, s. 10(a)(IX). This prohibition against deduction does not apply to amounts incurred from conducting a business of gambling.

Example 6.2.8.1

> Mr A won Rs. 1 million from a lottery. He spent Rs. 100,000 on lottery tickets for that draw. Mr A must recognize all Rs. 1 million as income from an investment but may not deduct the Rs. 100,000 as expenses incurred in the production of income from the investment.
> Assume Mr A runs an illegal gambling operation. The illegality of the operation does not preclude the income derived from income taxation. Mr A must recognize all income derived from the gambling operation as income from a business, and he may deduct expenses and losses incurred in conducting the business in accordance with Division IV of Chapter II.

Chapter 7 - Capital gains

For income tax purposes capital gain is treated as an investment income. The type of income is enumerated in paragraph (b) of subsection (2) of section 7 under source of investment income, as follows:

"(b) gains from realization of investment assets as calculated under Chapter IV" Accordingly, Capital gains tax (CGT) is charged on the gains arise from realization of investment assets.

The "**investment asset**" is defined in section 195 of the Act as follows:

investment asset -

(a) means a capital asset held as part of an investment, but –

(b) excludes the principal place of residence of an individual, provided it has been owned by the individual continuously for at least two of those three years (calculated on daily basis)"

As defined in section 195,

capital asset –

means each of the following assets: -

i. land or buildings;

ii. a membership interest in a company, partnership or trust;

iii. a security or other financial asset;

iv. option, right or other interest in an asset referred to in the foregoing paragraphs; but

excludes trading stock or a depreciable asset"

7.1 General Rules (Sections 36-41)

Division I of Chapter IV of the Act deals with general introduction to this Chapter.. The gain is calculated as the consideration received for the asset or liability exceeding the cost of the asset or liability at the time of realization.

In deciding the gain, the following factors need to be considered:

- Whether the asset is an investment asset as defined.
- the asset utilized prior to the realization was not in any manner connected to the business
- The gain calculated as explained below is does not exceed Rs. 50,000/- for resident individual

7.1.1 Calculation of gains and liability (Section 36)

A gain is realized when an asset is sold or exchanged at a price higher than its cost. Similarly, a loss occurs when an asset is sold for less than its cost. Gains or loss can be categorized as a business income or investment income. If it is an investment income the gain is a capital gain and if it is effectively connected to a business income, it is a trade profit and not a capital gain.

Therefore, a gain can be defined as a "Consideration received (Sec 38) for the asset or liability exceeds the cost of the asset (Sec 37) or the liability (Sec 40) at the time of realization (Sec 39)"

Consideration received	= ********
Less:	
Cost of an asset or Liability	= ********
Gain or loss	= ********

7.1.2 Cost of the assets and liability (Section 37)

Section 37 is discussed the matter of calculating of cost of an asset. Accordingly, the cost of an asset includes expenditure that incurred in acquiring of an asset, further it can be an improvement or any incidental expenses. The term incidental expenses have been defined in the Section 37(4) itself. Example: Advertisement expenses, transfer tax, stamp duty etc.

Subsection 2 of the section 37 further elaborate a situation where income amount also considers as a cost of an asset.

Following are the examples:

- Amount included in **person's income** (Employment/Business /investment/other income)
  Ex: Land given to employee as part of an employment income
- Amount received as **exempt income**– Third Schedule
  Ex: Bonds to diplomatic person as part of remuneration
- Amount received as **final Withholding payment**
  Ex: Lottery winning, rewards

Calculation Summary of Section 37

Expenditure incurred to acquire the asset	= *********
(Including *c*onstruction, manufacturing or production of the asset)	
Add: Expenditure incurred to altering the asset	= *********
(Improving, maintaining, repairing)	
Add: Incidental expenditure (acquiring or realizing)	= *********
(Advertising, transfer taxes, lawyer fee …)	
Add: Income amount	= *********
Cost of an asset	= *********

Special Note: Transitional Provisions - sec 203 (4)

According to the above provisions the cost of an investment asset held by a person as at, September 30, 2017 is equal to the market value of the asset at that time.

Example 7.1.2.1

Mr. X purchased a land for Rs 3,500,000 on 12.12.2015 and hold as his investment. The land and building value as at 30.09.2017 was Rs 4000, 000. X sold asset for Rs 6,000,000 on 1.05.2018 and incurred following expenditure before selling advertisement Rs 100,000, Brokerage fee Rs 60,000 and legal fee Rs 75000.

Sale consideration		6,000,000
Less: Value of the asset as on 30.09.2017	4,000,000	
Less: Cost of an asset		
Advertisement	100,000	
Brokerage fee	60,000	
Legal fee	75,000	4,235,000
Capital gain		1,765,000
Cost of an asset		2,000,000
Capital gain		176,500

7.1.3 Consideration received (Section 38)

Consideration received can be cash received or receivable by the person for an asset. The concept of consideration can be form of exchange one property instead of payment is cash to another in such a situation market value of the asset consider as consideration received.

Consideration received for an asset shall be,

(a) Amount received or receivable on the realisation -cash
In the case of consideration received other than cash - market value
Ex: Exchange of asset to another asset

(b) Amount received in respect of owning the asset
Ex : Altering ,repairing

(c) Amount received or entitlement to receive in future – advance
i. Grant of an option

ii. Consideration received for an asset shall not include an exempt amount or final WHT.

Example 7.1.3.i

Company A is a land developer. During year 1 it gives Mr Z, one of its executives, a plot of land as a bonus. The market value of the land is Rs 2 million. This amount must be included in calculating the income of Mr Z from the employment by Company A for year 1. Mr Z sells the land in year 3 for Rs2.2 million.

Sale consideration	2,200,000
Less:	
Cost of an asset	2,000,000
Capital gain	200,000

7.1.3.1 Grant of an Option

An option is an agreement between the grantor, or writer, and the grantee. Typically, the grantor gives the grantee the right to buy or to sell a specified quantity of something such as shares, land or any capital assets at a price fixed by the option agreement. This right can only be exercised during a specific period or on a specific day.

Example 7.1.3.ii

B pays to Mr A Rs 1,000,000 for the grant of an option entitling the holder to acquire a land from A for Rs 5 M.. Mr B subsequently did not exercise the option and sell the option to Mr C for Rs 2 M.

Mr A Tax Liability

Consideration	= 1,000,000
Cost	= --------
Gain	= 500,000

Mr B Tax Liability

Consideration	= 2,000,000

Cost of acquisition	= 1,000,000
Gain	= 1,000,000

7.1.3.2 Realization (Section 39 and 43)

Capitan gain arises when assets are sold, Section 39 (a) and (b) deal with the situation where person apart with ownership of the asset physically by way of sold, exchanged, transferred, destroyed, lost, expired etc. The death of person considers as realization of asset immediately before the death. The special provisions given in the section 44.

Deem realization

Section 39(c) to 39 (f) discussed the matter of deem realization. This means that ownership of the assets is not actually transfer to another person, deem realization take place.

7.1.3.3 Liability (Section 40)

Section 40 deals with the determination of the cost and the consideration received for liability similar to assets and subsection (1) provides for the calculation of cost of liability and consideration received, similar to the calculation of assets in section 37 and section 38 respectively.

Subsection (2) explains the special circumstances treated as realizing the liability which will arise, when person ceased to owe the liability by way of

- Transfer, satisfy, cancel
- Death
- Change in residence

7.1.4 ***Reversal*** quantification and compensation of amount (Section 41)

7.2 Special Rule (Sec 42-51)

7.2.1 Cost of trading stock and other fungible assets (Section 42)

- This is discussed under business income.

7.2.2 Realization with retention of asset (Section 43)

In this section deemed realization and deemed reacquiring the assets of the person who realizes assets in the manner set out in paragraphs (c) to (f) of section 39 are dealt with.
The way of calculation of gain or loss when deemed disposal take place should be made as per section 43.

Deemed disposal - refers to a situation where it is considered to have been disposed even that investment asset has not actually transfer to.

Deemed proceeds of disposal – refers to a situation that the consideration deemed to have been received and the value is equal to the market value, even though the consideration has actually not received.

Deemed cost – refers to reacquire the asset and incurring expenditure of the amount equal to deemed realization.

Example 7.2.2.1

A is a resident individual who owns apartments in Sri Lanka as well as India. He leaves Sri Lanka and decides to move India permanently Sec 70(3). According to Section 43, Mr. A is treated as realizing apartment situated in India immediately before he ceases to be resident in Sri Lanka but not his domestic asset in Sir Lanka.

Even though Mr. A does not sell his apartment situated in India actually, according to section 39(f) it is considered as a realization. (deem realization)

7.2.3 Transfer of asset to spouse or former spouse (Section 44)

The transfer of asset to spouse of former spouse on death, or as part of a divorce settlement or bone fide separation agreement the gain calculated as following formula and for this purpose written consent is required.

Sec 44 (a) Individual deriving an amount equal to net cost (realisation)

Realisation = Net Cost of the asset

Sec 44 (b)

Person who acquire ownership of asset equal to net cost

Acquisition cost = Net Cost

Therefore, by applying above formula, gain will not arise.

7.2.4 Transfer of asset on death (Section 45)

Sections 39(b) and 40(2)(b) provide that an individual is treated as realizing all of his or her assets and liabilities immediately before his or her death. In principle, the deceased is treated as receiving 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 the 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.

7.2.5 Transfer of asset to an associate or for no consideration. (Section 46)

This section provides for the transfer of any type of asset, it can be business asset of investment asset by way of transfer ownership to associate or giving gift. Sec 46(2) and (4) provides exception to general rule 46(1).

46(2) provided exception to the general rule for an individual and charitable institutions who transfer land or a building situated in Sri Lanka for the associate in relation to the individual. If individual transfers capital asset other than land and building 46(1) apply and gain calculated accordingly. The term associate has been defining in the sec 46(3) (a)

Example 04:

Mr. A transferred his asset to his son as follows. Land and building situated in Sri Lanka,

Asset	**Net Cost**	**Market value**	**Applicable Section**	**Tax liability**
Land and building	5 M	10 M	46(2)	No gain
Family home	3 M	4 M	Exempt	Exempt
Unlisted shares	2 M	4 M	46(1)	2 M capital gain

In the given scenario Mr. A and Mr. D are associates under section 46(3)(a) and also land is situated in Sri Lanka. A residential house is exempted under Third Schedule. Unlisted shares are not covered in the 46(2) then gain on realization of shares are subject to Capital gain tax and calculation as follows

Sale consideration	4,000,000
Less:	
Cost of an asset	2,000,000
Capital gain	2,000,000

Section 46(4) permits the non –recognition of a gain that would otherwise require to recognized where a person transfer ownership of a business asset. Subject to fulfillment of conditions.

7.2.6 Involuntary realization of asset with replacement (Section 47)

This section explains the CGT obligations if the CGT asset is compulsorily acquired.

There may be a situation where a person receives money or another CGT 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

- Realize an asset in manner set out in Sec 39 (a)
- Acquires a replacement asset of same type, within six months before or after one year of realization.
- Need to lodge a written election stating your choice

If above conditions are satisfied.

Realization	=	Net cost	+	If Compensation received exceeds cost of replacement asset
Cost of replacement asset	=	Net cost	+	If cost of replacement asset exceeds compensation received

Mr. A Purchased building and net cost Rs 2,500,000. Asset value as at 30.09.2017 Rs 3,000,000 and the asset destroyed due to fire and asset was insured and insurance claim received Rs 3,000,000. A replace the asset for Rs 2,500,000. Assumed that all three conditions are satisfied.

Realization	=	Net cost	+	If Compensation received exceeds cost of replacement asset

Realization	= 2,500,000 + 500,000 (3 M -2.5 M)
	= 3,000,000
Cost of asset (Net cost)	= 2,500,000
Gain/loss	= 500,000 (3,000,0000-2,500,000)
Cost of replacement asset compensation	= Net cost + (If cost of replacement asset exceeds received)
	= 2,500,000 + 0 (4M-4.5M)

7.2.7 Realization by separation (Section 48)

Section 48 is 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 this sort of case is whether the rights created amount to a part realization 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 "temporary or contingent" then there is the creation of a new asset. If the rights or obligations are "permanent" then there is a part realization. Under s. 48(2), rights or obligations created are permanent if they exceed 50 years. So, if a person who owns land grants a lease for more than 50 years it will be treated as a part realization of the land. If the person grants a lease for less than 50 years it will not be a part realization but, rather, the owner of the land will acquire a new asset, i.e. the lease.

Rights or obligations are contingent if they are not effective until the happening of an event or if they cease to have effect on the happening of an event.

7.2.8 Transfer by way of security, finance lease or instalment sale (Section 49)

How to calculate gain on realization on treasury bills.

Example 7.2.8.1

Mr X bought a treasury bill on 01.05.2018 for Rs 49,500,000. The T-bill's term is 91 days and maturity value on 01.08.2018, is Rs 50,000,000. However, he sold it on 13.06.2018 for Rs 49,750,000. The effective yield rate was 4.05.

1. Calculation of interest =Purchase price * Effective Yield*Number of days T –bill held/365

   =49,500,000*4.05%*44/365

   = 241,668

2. **Calculating capital gain**

   Sale consideration = Rs 49,750,000

   Less: Interest = 241,668

   Net Consideration

   Less: Cost = Rs. 49,500,000

   Capital Gain = Rs. 8,332

7.2.9 Apportionment of cost and consideration received. (Section 50)

Where a person acquires more than one asset or liability or realises more than one asset or liability. The market value and net cost have to apportionment between assets.

Administration Provisions

7.2.10 Filling of CGT

A person disposing of a capital asset should be required to file a CGT return within one month after the realization of the capital asset. The CGT tax is imposed on a transactional rather than periodic basis. Consequently, a separate return must be file in respect of each transaction.
A person who fails to file tax return on or before the due date shall be liable to pay a penalty as per Section 178.

Ex: Mr X realized his land on 01.05.2018 and Mr X need to submit return on or before 01.06.2018.

7.2.11 Payment of CGT

The CGT payable by a person on the disposal of a capital asset should be due on the date for filling the tax payer's CGT return in respect of realization**.** Where the Commissioner General is satisfied that an investment asset has been realised in two or more parts then instalment payment can be paid and tax credit will be available.

Ex: Mr X realized his land on 01.05.2018 and Mr X need to submit return on or before 01.06.2018

7.2.12 Exemption

Capital gain exemptions are limited and mentioned in the Third Schedule.

- A capital gain that does not exceed an Rs 50,000 is exempt from capital gain tax and where the total gains made by the resident individual from the realization of investment assets in the year of assessment do not exceed Rs. 600,000,

- This exemption is applying for the joint –owned property so that the exemption applies only if the total capital gain made by all the joint owners of the property does not exceed the Rs 50,000.

Example 7.2.12.1:

The capital Gain arise from realization of land amount to Rs 1500,000/=. Land is owned by three individual equally, then each individual share equal to 331/3%. but Rs 50,000 allowance is apply for the total gain not for the individual portion. Then calculation as follows.

	Rs .
Capital gain	= 150,000
Joint ownership share	= 331/3%
Taxable Capital gain for each individual	= 50,000
Tax on Capital gain	= 5,000

- A capital gain arises by a resident individual on disposal of individual's principle place of residence is exempted provided it has been owned by the individual continuously for the three years before being realized and lived in by the individual for at least two of those three years (calculated on a daily basis)

- Gain made on realization of an asset consisting of shares quoted in any official list published by any stock exchange licensed by the Securities and Exchange Commission of Sri Lanka.

7.2.13 Capital Loss

As per Section 19(5) Capital loss cannot be set-off against any capital gain (nor deductible against other forms of taxable income)

Chapter 8 - Method of Accounting

As income tax is imposed under s. 2(1) for each year of assessment, the amounts used in calculating income tax must be allocated to specific tax years. This allocation process is primarily detailed by Chapter III, Division I. "Year of assessment" is defined in s. 20. As a general rule, the year of assessment is the year ending 31 March. Therefore, the year of assessment 2018 is the period from 1 April 2017 to 31 March 2018. A company or trust can apply to the IRD for a change to the last day of the year of assessment, s. 20(2). The IRD will generally approve such applications where the accounting year end of the company is not 31 March. If so approved, the IRD may impose such reasonable terms and conditions as it may consider necessary or desirable to ensure that tax is properly accounted for.

As a general rule, taxpayer should adopt a cash or accrual basis based on whichever properly computes the person's income, s. 21(4). However, business income must always be accounted for on an accrual basis, and all individuals must account for employment or investment income on a cash basis, s. 21(2) and (3). Cash basis accounting and accrual basis accounting are defined in ss. 22 and 23 of the Act. In determining the timing of inclusions and deductions in calculating a person's income, one must follow generally accepted accounting principles, unless otherwise provided by the Act, s. 21(1).

The remainder of Chapter III, Division I deals with other specific tax accounting treatment issues. Two of these, namely, reverse of amounts (including bad debts) and long- term contracts, are discussed in detail in this Manual under the section entitled "

Chapter 9 - International

9.1 Residence & Source

Sri Lanka bases its income tax on the usual dual jurisdictions of residence and source. Residents are taxable on their worldwide income whereas non-residents are only taxable on their income that has a source in Sri Lanka. The concept of **residence is set out in s. 69** and the concept of **source in s. 71.**

9.1.1 Residence – Individuals& Others (Section 69)

A. Individual

Individual's residency is decided based on two **Primary Test and** two **Residual Test**

Primary Test

Person is considered to be a resident in Sri Lanka, if he;

i. Resides in Sri Lanka - para (1)(a)

As there is no definition for "reside"., therefore general meaning has to be taken.

- Availability of a permanent home in SL, location of individual's family in SL would amount to reside in SL.
- Is present in Sri Lanka for 183 days or more during any year of assessment- para (1)(c)

Residual Test

- Is a Government employee or an official?
- spouse of the official is stay with the official?
- Is an individual employed on a Sri Lanka ship within the meaning of Merchant Shipping Act?

B. Partnership

A partnership is considered to be resident in Sri Lanka, if;

i. **It is formed** in Sri Lanka – para (2)(a).
ii. the **management** and **control** of the affairs of the partnership are exercised in Sri Lanka – para (2)(b).

the management and control of the affairs of a partnership is considered to be exercised in Sri Lanka during that year of assessment, if at least one of the partners of the partnership is in Sri Lanka during that year, unless it can be demonstrated on the facts that none of the partners in Sri Lanka has any management and control over the business of the partnership.

C. Trusts

A trust is considered to be resident in Sri Lanka if;

i. A trust **settled or established** in Sri Lanka– para (3)(a).
ii. one of the trustees of the trust is resident in Sri Lanka – para(3)(b)
iii. a resident person directs or may direct senior managerial decisions of the trust, whether the direction is or may be made alone or jointly with other persons, or directly or indirectly – para (3)(c).

D. Companies

A company is considered to be a resident in Sri Lanka, if;

i. A company was incorporated or formed under the laws of Sri Lanka – para (4)(a).
ii. Its registered or principal office is in Sri Lanka – para (4)(b)
iii. if at any time during the year of assessment the management and control of the affairs of the company are exercised in Sri Lanka – para (4)(c)

The decision-making body of a company is usually its board of directors. Where there is more than one decision-making body in a company, the management and control of the business of that company lies with the body holding the **paramount authority on major questions of policy**. The residence of a company is to be determined by its actual place of management and control, based on the actual circumstances of the company and not through the interpretation of the constitution or by-laws of the company.

Although the management and control of a company generally lies with its board of directors, such management and control may be usurped by an outsider, such as the **holding company**, where the company´s board of directors stand aside from their directorial duties and do not purport to function as a board of management. However, the control and management of a company is not usurped by an outsider who instructs the board of directors on what to do, so long as the board exercises its discretion when making decisions and would have refused to carry out an improper or unwise transaction.

Change of residence – An individual is treated as a resident in Sri Lanka only by reason of paragraph (c) of sub section (1) of section 69, shall be so resident from the start of the one hundred and eighty-three-day period. If not a person who is resident in Sri Lanka during a year of assessment shall be treated as a resident for whole of the year.

9.1.2 Source - Section 71& 72

Calculation of Foreign Source Income/Loss – Section 71

- **Employment income/loss from foreign source =**

  Worldwide income/loss from **employment**
  Less
  income from **Employment** in SL

- **Business or Investment income/loss from foreign source =**

  Worldwide income/loss from **Business or Investment**
  Less
  income from **Business or Investment** in SL

- **Deduction of Business or investment losses – Section 19(1)**

  - An unrelieved loss for the year from that business and an unrelieved loss of the person any of the previous six years of assessment from that business or any other business.
  - If a loss were a profit and it could be taxed at a reduced rate, the loss shall be deducted only in proportion to the same reduced rate.

- **Deduction of unrelieved foreign source loss**
  - unrelieved foreign source loss from an **investment** could be deducted only from a person's foreign source income from an **investment**.
  - unrelieved foreign source loss from **business** could be deducted only from a person's foreign source income from **business or investment**.

Income Source in Sri Lanka – Section 72

There are two broad categories of amounts that may be included in calculating income as having a source in Sri Lanka:

A. those amounts relating to the **realisation or disposal of domestic assets**(s. 195) **and liabilities (**as defined in s. 103(2)), s. 72(1)(a); and
B. **other types of payments** that has a source in Sri Lanka. - s. 72(1)(b).

A. **The domestic asset and liabilities related amounts under s. 72(1)(a) specifically comprise the following**:

(a) consideration received in respect of domestic trading stock of a business, s. 6(2)(b);
(b) gains as calculated under Chapter IV from realization of
  (i) capital assets and liabilities of a business, s. 6(2)(c);
  (ii) investment assets, s. 7(2)(b); and
(c) balancing charges to be included by the Fourth Schedule on realization of depreciable assets of a business, s. 6(2)(d).

B. **Other types of payments** -Payments with a source in Sri Lanka under s. 72(1)(b) are set out in an exhaustive list under s. 73(1). [anything not covered under s. 73(1) is treated as foreign sourced, s. 73(2)]. Some of the main types of payments deemed to have a source in Sri Lanka under s. 73(1) include:

(a) payments received in respect of employment to the extent derived in respect of **employment exercised in Sri Lanka**, regardless of where they are paid, or if paid by or on behalf of the Sri Lanka Government, regardless of **where employment is exercised**, s. 73(1)(a);

Example:9.1.2.1

.

Mr Z works as a software engineer for a software development company, Company A. Company A has entered into an agreement with Company B in India, under which Company A will help Company B develop a new software. Mr. Z was sent by Company A to India for three months as part of this project to provide software engineering services onsite. Mr. Z's annual salary is LKR 800,000.

As Mr Z has exercised employment in Sri Lanka for only nine months during the year, only LKR 600,000 (i.e. one quarter of LKR 800,000) of his wages will have a source in Sri Lanka, s. 73(1)(a)(i). The remaining LKR 200,000 is foreign sourced, s. 73(2). Nevertheless, as Mr. Z is resident in Sri Lanka for that year, s. 69(1)(c), he will be taxed on his worldwide income and therefore all LKR 800,000 will still be taxed under s. 5(2)(a).

Assume now instead that Mr. Z works as a software engineer for the Government of Sri Lanka and has been seconded for three months to the Department of Statistics of the government of Country C to learn how commercial software are customized and employed by the Department of Statistics for its daily operations and how this can be similarly used in Sri Lanka. Although Mr. Z exercised his employment in Country C during the three months, all LKR 800,000 of his wages will be considered to be sourced in Sri Lanka as it is paid by the Government of Sri Lanka, s. 73(1)(a)(ii).

(b) dividends paid by a resident company, s. 73(1)(b);

(c) interest, charges, annuities, royalty, technical service fee (as defined in s. 74) or similar payment paid by:

(d) a resident person, except where it is an expense of a business carried on through a permanent establishment outside Sri Lanka, s. 73(1)(c)(i);

(e) a non-resident person as an expense of a business carried on through a permanent establishment in Sri Lanka, s. 73(1)(c)(ii);

Example 9.1.2.2

Consider the facts in above *Example.* Assume that Mr A has obtained two business loans, one for his retail store in Sri Lanka and one for the store in India.

In year 1, Mr. A is still a tax resident. Therefore, interest paid on the loan for the Sri Lanka store in year 1 will have a Sri Lanka source, but not the interest for the loan for the India store (which is foreign sourced) as it is the expense of a business carried on through a permanent establishment outside Sri Lanka (even though it is paid by a resident person), s. 73(1)(c)(i).

In year 2, Mr. A is a non-resident. The interest paid on the loan for the Sri Lanka store in year 2 will still have a Sri Lanka source as it is the expense of a business carried on through

a permanent establishment in Sri Lanka, s. 73(1)(c)(ii). The interest paid on the loan for the India store in year 2 continues to be foreign sourced as it is paid by a non-resident person and is not the expense of a business carried on through a permanent establishment in Sri Lanka.

(f) rent paid for the use of, right to use or forbearance form using an asset situated in Sri Lanka, s. 73(1)(f);

(g) payments received by a person who conducts a telecommunication or electronic communication business where the messages transmitted by apparatus established in Sri Lanka, even if the messages do not originate in Sri Lanka, s. 73(1)(i); and

(h) all residual fees and payments (including service fees) for or attributable to service rendered or a forbearance from rendering services in Sri Lanka, regardless of the place of payment, or if paid by the Sri Lanka Government, regardless of the place of rendering or forbearance, s. 73(1)(j).

9.2 Double Taxation Agreements (DTA) & Mutual Administrative Assistance Agreements (MAAA)

Division ll - Section 75

Bilateral or Multilateral Agreements; Double Taxation Agreements (DTAA) and Mutual Administrative Assistance Agreements would be effective after approved by Parliament, and published in the Gazette by the Minister.

Double Taxation Agreement is an international agreement relating to the avoidance of double taxation and the prevention of fiscal evasion. If there is a conflict between terms of Double Taxation Agreement in force and the provisions of Inland Revenue Act the provisions of the Double Taxation Agreement will prevail.

If by the provisions of the DTAA provides for tax on income from SL source to be exempt, excluded or reduced this benefit would be available only to residents of other contracting State persons, only if;

a. **being a body of persons - 50% of the underlying ownership or control of that body is held by resident individual or individuals** of that contracting state or,

b. **Company – Listed in the other contracting state**.

As at 01.01.2018 there are 44 bilateral DTAAs in forced in Sri Lanka and is as follows;

DETAILS OF SRI LANKA DOUBLE TAXATION AVOIDANCE AGREEMENTS IN FORCE

As at 30.04.2017

	Country	Date of Signing the Agreement	Gazetted		Date of Entry into Force		Operative in Sri Lanka From the Year of Asst.
			Gazette No.	Date	Date of Notification	Exchange of Instruments of ratification	
1	Australia	18-Dec-1989	657/2	8-Apr-1991	-	21-Oct-1991	1992/93
2	Bangladesh	24-Jul-1986	448/13	7-Apr-1987	-	7-Jun-1988	1989/90
3	Bahrain	24-Jun-2011	1847/51	31-Jan-2014	31-Jan-2014	13-Aug-2013	2015/16
4	Belgium	3-Feb-1983	292/6	9-Apr-1984	-	28-May-1985	1984/85
5	Canada	23-Jun-1982	253/8	13-Jul-1983	-	30-May-1986	1986/87
6	China	11-Aug-2003	1374/20	6-Jan-2005	22-May-2005	-	2006/07
7	Czechoslovakia (Czech Republic)	23-Feb-1979	24/19	23-Feb-1979	19.07.1979		1979/80
8	Denmark (Rev.)	22-Dec-1981	228/15	20-Jan-1983	28-Feb-1983	-	1980/81
9	France	17-Sep-1981	210/17	17-Sep-1982	26-Nov-1982	-	1982/83
10	Finland	18-May-1982	253/8	13-Jul-1983	27-Feb-1984	-	1981/82
11	Germany (Rev.)	13-Sep-1979	113	31-Oct-1980	-	21-Oct-1982	1982/83
12	Hong Kong (Limited)	26-Mar-2004	1374/21	6-Jan-2005	29-Mar-2005	-	2005/06
13	India (Rev.)	22.1.2013	1828/9	17.09.2013	23.10.2013	23.10.2014	2014/15
14	Indonesia	3-Feb-1993	789/10	21-Oct-1993	-	21-Jun-1994	1995/96
15	Iran	25-Jul-2000	1187/16	6-Jun-2001	-	26-Dec-2001	2002/03
16	Italy	28-Mar-1984	322/4	5-Nov-1984	-	9-May-1991	1978/79
17	Japan	12-Dec-1967	14803/5	29-May-1968	-	22-Sep-1968	1969/70
18	Korea	28-May-1984	342/11	29-Mar-1985	-	20-Jun-1986	1980/81
19	Kuwait	5-Feb-2002	1245/19	18-Jul-2002	23-Feb-2004	-	2002/03
20	Malaysia (Rev.)	16-Sep-1997	1028/21	22-May-1998	14-Oct-1998	-	99/2000
21	Mauritius	12-Mar-1996	958/10	15-Jan-1997	2-May-1997	-	1998/99
22	Nepal	6-Jul-1999	1116/6	26-Jan-2000	31-May-2000	-	2001/02

23	Netherlands	17-Nov-1982	281/13	26-Jan-1984	24-Jan-1985	-	1979/80
24	Norway (Rev.)	1-Dec-1986	464/4	27-Jul-1987	-	8-Mar-1988	1989/90
25	Oman (Limited)	26-Jul-1994	881/7	26-Jul-1995	23-Oct-1995	-	1979/80
26	Pakistan (Rev.)	15-Oct-1981	210/17	17-Sep-1982	-	18-Jun-1983	1983/84
27	Philippines	11-Dec-2000	1237/7	21-May-2002	8-Dec-2009		2010/11
			1256/27	2-Oct-2002			
28	Poland (Parliament)	25-Apr-1980	130	27-Feb-1981	-	21-Oct-1983	1984/85
29	Qatar	7-Nov-2004	1422/10	5-Dec-2005	3-May-2007	-	2008/09
30	Romania	19-Oct-1984	371/9	15-Oct-1985	-	28-Feb-1986	1986/87
31	Russia	2-Mar-1999	1101/22	15-Oct-1999	28-Dec-2002	-	2003/04
32	Saudi Arabia (Limited)	16-Dec-1999	1101/23	15-Oct-1999	-	11-May-2000	1983/84
33	Singapore (Revised)	3-Apr-2014	1993/11	16-Nov-2016	-	1-Jan-2018	2018/19*
34	Sweden (Rev.)	23-Feb-1983	297/28	18-May-1984	30-Jul-1984	-	1985/86
35	Switzerland	11-Jan-1983	292/6	9-Apr-1984	-	14-Sep-1984	1981/82
36	Thailand	14-Dec-1988	571/16	18-Aug-1989	-	27-Feb-1990	1990/91
37	U.A.E. (Limited)	7-Jul-1992	824/13	23-Jun-1994	8-Aug-1994	-	1979/80
	U.A.E. (Comprehensive)	24-Sep-2003	1346/1	21-Jun-2004	11-Oct-2004	-	2004/05
38	U.K.	21-Jun-1979	60/23	2-Nov-1979	21-May-1980	-	1977/78
39	U.S.A	14-Mar-1985	398/4	22-Apr-1986	-	-	2004/05
	U.S.A.Protocol	20-Sep-2002	1298/8	21-Jul-2003	-	12-Jul-2004	
40	Vietnam	26-Oct-2005	1455/9	24-Jul-2006	28-Sep-2006	-	2007/08
41	Seychelles	23.09.2011	1837/14	20.11.2013	26.03.2014		2015/16
42	Luxembourg	31.01.2013	1838/9	26.11.2013			2015/16
43	Palastine	16.04.2012	1838/8	26.11.2013			2015/16
44	Belarus	26.08.2013	**1837/13**	20.11.2013	12.02.2014		2015/16
	SAARC	**13.10.2005**	**1447/3**	2006.5.29			2011/12

* With regard to WHT in Sri Lanka the effective in Sri Lanka from 1st January 2018.

An updated list is provided in the IRD Website.

9.3 Foreign tax credit

As for the purpose of section 80 a resident person may claim foreign tax credit for a year of assessment on any foreign income tax paid by the person and to the extent to which the foreign income tax is paid with respect to the person's assessable foreign income for the same year of assessment.

Section 81 sets out the manner in which foreign tax credit may be claimed for any tax payable in respect of foreign income tax paid within 2 years after the end of the year in which such foreign income is derived by a resident person. There are a number of important restrictions on or limitations to a claim to foreign tax credit.

- Foreign tax credit shall be calculated separately for each year of assessment and separately for assessable foreign income from each employment, business, investment or other source and further separately for each gain from the realisation of an investment asset,
- Foreign tax credit may generally only be claimed by a resident individual or a resident company. A resident partnership as an entity is not entitled to claim foreign tax credit, except to the extent that the foreign tax paid is in relation to gains from the realization of an investment asset. Similarly, a resident trust as an entity is not entitled to claim foreign tax credit on foreign tax paid on its income in respect of which a beneficiary (instead of the trust) is liable to tax, except to the extent that such income on which the beneficiary is liable to tax consists of gains from the realisation of an investment asset. See s. 80.

Example 9.3.1:

> Trust A, a resident trust, has foreign rental income and capital gains from the realisation of certain foreign investment assets for the year of assessment 2018. Trust A has paid tax on the income and gains in the respective foreign countries. Mr Z, a resident beneficiary, has a vested and indefeasible interest in the entire corpus of the trust assets and have an immediate right to demand payment of all income from the trustee of the trust, i.e. Mr Z is presently entitled to the income. Trust A will not be entitled to claim foreign tax credit on the foreign tax paid in respect to the foreign rental income but will be entitled to do so on the foreign tax paid in respect to the gains from the realisation of the foreign investment assets. However, Mr Z will be entitled to claim foreign tax credit on the foreign tax paid in respect to the foreign rental income.

- The foreign tax credit allowable for set off against the Sri Lanka tax payable on each type of income or for gains from realisation for each asset, the maximum amount of foreign tax credit claimed may not exceed the average rate of Sri Lankan income tax of the person for the year applied to the person's assessable foreign income, s.81(b). The average rate of Sri Lankan income tax of the person is computed as follows:

(A/B) * 100%

Where;

A - tax payable by the person on his taxable income (before foreign tax credit is applied),

B - the taxable income of the person for the year.

This average rate of Sri Lankan income tax of the person is applied to the assessable foreign income of the person, i.e. foreign sourced income included in the assessable income of a resident person for a year of assessment from an employment, business, investment or other source, as the case may be. The resultant value will be the maximum amount of foreign tax credit available to the person. To the extent that the actual foreign tax paid is lower than this maximum amount, only the actual amount of foreign tax paid will be allowed as a foreign tax credit.

- Any foreign tax credit that is not fully utilized in the year will not be refunded, carried back to an earlier year of assessment or carried forward to a subsequent year, s. 81(3)

Example 9.3.2:

Company A is a resident of Sri Lanka with LKR 800,000 of business income with a Sri Lanka source and LKR 200,000 of foreign sourced business income from Country Z for the year of assessment 2018. Assume Company A is taxed in Country Z on the LKR 200,000 at 40%, i.e. LKR 80,000.

Company A, being a resident, is taxed on its worldwide income, i.e. all LKR 1 million of business income, at 28%, i.e. LKR 280,000. Its average rate of Sri Lankan income tax will be 28%, and the assessable foreign income is LKR 200,000. As such the foreign tax credit allowable to Company A for the year of assessment 2018 will be LKR 56,000, i.e. 28% * LKR 200,000. Company A can deduct up to LKR 56,000 of foreign tax credit against its Sri Lanka tax liability, but the excess LKR 24,000 of foreign tax paid will be disregarded and cannot be refunded, carried back to an earlier year of assessment or carried forward to a subsequent year.

- Foreign tax credit is calculated for each year of assessment on a "source-by-source" and "asset-by-asset" basis. Any excess foreign tax paid on gains from the realisation of one investment asset cannot be used to set off against the Sri Lanka tax payable on gains from the realisation of another investment asset, even if they are of the same class or type of asset. See s. 81(a).

Example 9.3.3:

Mr. A is a resident and has the following types of income:

<u>Business A</u>
Sri Lanka sourced business income – LKR 2 million
Foreign sourced business income – LKR 1 million

<u>Business B</u>

Sri Lanka sourced business income – LKR 400,000
Foreign sourced business income – LKR 2 million

Investment C
Gains from realization of foreign investment assets – LKR 500,000

Investment D
Gains from realization of domestic investment assets – LKR 800,000

Assume the foreign tax rates for the foreign sourced business and investment gains are the same at 40%. This means Mr A has paid LKR 400,000, LKR 800,000 and LKR 200,000 of foreign tax on business A, business B and investment C, respectively.
Tax payable for business A – LKR 360,000 (progressive personal tax rate)
Tax payable for business B – LKR 240,000 (progressive personal tax rate)
Tax payable for investment C – LKR 50,000 (10%)
Tax payable for investment D – LKR 80,000 (10%)

Mr. A's average rate of Sri Lankan income tax in respect of business A, business B and investment C is 12% (LKR 360,000 tax payable divided by LKR 3 million taxable income), 10% (LKR 240,000 tax payable divided by LKR 2.4 million taxable income) and 10% (LKR 50,000 tax payable divided by LKR 500,000 taxable income), respectively.

Therefore, the maximum foreign tax credit allowable to Mr A on a "source-by-source" and "asset-by-asset" basis will be LKR 120,000 for foreign sourced income for business A (12% * LKR 1 million), LKR 200,000 for foreign sourced income for business B (10% * LKR 2 million) and LKR 50,000 for foreign investment C gains (10% * LKR 500,000).

The Sri Lanka tax position of Mr. A after foreign tax credit is as follows:
Tax payable for business A – LKR 240,000 (LKR 360,000 less LKR 120,000)
Tax payable for business B – LKR 40,000 (LKR 240,000 less LKR 200,000)
Tax payable for investment C – LKR 0 (LKR 50,000 less LKR 50,000)

The foreign tax credit in respect of investment C cannot be utilized against the realization gains for investment D.

Chapter 10 - Transfer Pricing

Act provides separate provisions in Section 76 and 77 to deal with transfer pricing respectively for international and local transactions. Section 76 and 77 requires that all transactions between associated enterprises in Sri Lanka shall be at arm's length price. The arm's length price to be determined having regard to the application of the most appropriate method to the facts and circumstances of the case from any of the methods specified by Commissioner General in Transfer Pricing Regulations. Commissioner General is to issue Regulations specifying Transfer Pricing Rules.

10.1 International Transaction

International transaction is defined in Section 76 to be a transaction between two or more associated enterprises, either one or both of whom are non-residents, in the nature of;

- purchase, sale or lease of tangible or intangible property, or
- provision of services,
- lending or borrowing of money or
- any other transaction having a bearing on the income, gain or profits, losses or assets of such associated enterprises, and
- any allocation or apportionment of, or any contribution to any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such associated enterprises under any mutual agreement or arrangement between two or more such associated enterprises.

10.2 Permanent Establishment (PE)

For the purposes of section 76 and 77 a person includes a PE. A PE is deemed to be a person in Sri Lanka and any transactions between a PE in Sri Lanka and its Head Office and other related branches are considered to be transactions between two distinct and separate entities.

For the purposes of Section 76, a PE in Sri Lanka would be;

- any person and their agencies, branches or establishments in Sri Lanka in relation to any country with an agreement has been entered into on avoidance of double taxation agreement
- if there is no double tax avoidance Agreement, any business connection or a fixed place of business through which the business of the enterprise is wholly or partly carried out irrespective of the number of days of such business carried out in Sri Lanka;

- **TP Audit Procedure -** Transfer pricing issues on international transactions and local transactions are to be audited by transfer pricing officer and an Assistant Commissioner respectively and issue a preliminary order to the Technical Review Committee (TRC). TRC in reviewing the determined arm's length price in the preliminary order shall confirm, reduce or enhance the determined arm's length price. If all the members of the TRC are in agreement to issue a final order and if not so to issue an interim order.

A taxpayer in receipt of an interim order if dissatisfied of such order, can communicate such dissatisfaction to the Dispute Resolution Panel (DRP). An order issued by the DRP and an interim order that is not referred to the DRP by a taxpayer would also be consider as a final order.

A notice of assessment would be raised in accordance with the final order. Commissioner General would further specify the applicable audit procedure in the Transfer Pricing Regulations.

- **Technical Review Committee & Dispute Resolution Panel –** Commissioner General to specify the composition of TRC and DRP in Transfer Pricing Regulations.

- **Limitation of the application of provisions of Sec 76 & 77** – The provisions of section 76 and 77 would not apply if the computation of income under these provisions would result,
  - reduction of income, gain or profit chargeable to tax, or
  - increase of loss.

- **Safe Harbour Rules -** Determination of arm's length price of transactions between associated enterprises would be subject to safe harbour rules specified by the CGIR. Section 76(7) and 77(5).
  "safe harbour" means circumstances in which the Commissioner-General may propose a simplification measure that shall accept the transfer price declared by a person under certain conditions;

10.3 MUTUAL ADMINISTRATIVE ASSISTANCE AGREEMENTS

Mutual Administrative Assistant Agreement is an Agreement for tax information exchange agreement or international agreement for mutual administrative assistance in relation to taxation matters. Sri Lanka has not yet entered in to any Mutual Administrative Assistance Agreements.

Chapter 11 - Rules governing on taxation of types of persons

11.1 Individuals

11.1.1 Qualifying Payments and Reliefs for Resident Individuals and Entities

Qualifying payments and reliefs, if any, should be subtracted in computing the taxable income of a person for a year of assessment, under S. 3(1). Note that qualifying payments, if available, may be deducted by any individual or entity regardless of such individual or entity tax residence status. In contrast, only resident individuals may avail themselves to reliefs, if any, under S.52 and the paragraph (2) of the Fifth Schedule to the act (except the relief referred to in paragraph 2(a) of the Fifth Schedule).

Broadly, qualifying payments are donations made to the Government and local authorities (including funds established by the Government and approved funds established by local authorities), as well as certain statutory bodies and funds and charitable institutions. On the other hands, reliefs, are generally allowable as long as the person is resident in Sri Lanka for tax purposes and meets the qualifying conditions.

11.1.2 Qualifying payments

Paragraph 1(a) of the Fifth Schedule to the act, deals with donations to approved charitable institutions. Only monetary donations made to approved charitable institutions are treated as qualifying payments. In addition, there is a cap on the amount of monetary donation that can be subtracted as qualifying payment in a year of assessment.

Paragraph 1(b) of the Fifth Schedule to the Act deals with donations to the Government and local authorities (including funds established by the Government and approved funds established by local authorities), as well as certain statutory bodies and funds. Profits remitted by a public corporation to the President's Fund (established by the President's Fund Act, No. 7 of 1978) are also qualifying payments under paragraph 1(c) of the Fifth Schedule to the act, if such remittance is required by the law under which the public corporation is established.

Contrasting donations made to approved charitable institutions, a donation or remittance under paragraph 1(b) or (c) of the Fifth Schedule to the Act need not be in monetary form (i.e. Donation can be made in money or otherwise) and is not subject to any cap.

No provisions available to carry forward any excess payments over the taxable income, to subsequent years of assessment to any donations made under paragraph 1(a), 1(b) or 1(c) of the Fifth Schedule to the act. However, could be claimed up to the limit of taxable income of that year

of assessment. The following table explains the cap applicable for donations made to approved charitable institutions.

Donations made to	Maximum amount deductible	
	Individual	Entity
Approved charities (Monetary donations)	**Lower of:** ► 1/3 of the taxable income or LKR 75,000	**Lower of:** ► 1/5 of the taxable income or ► LKR 500,000
Government or Prescribed institutions (in money or otherwise)	100%	100%

Example 11.1.1-1

Mr. Kamal has taxable income of Rs 3 million for the year of assessment 2018. In that year, he made a monetary donation of Rs 200,000 as well as a valuable furniture worth Rs 500,000 to an approved charitable institution. In addition, he also made a donation of Rs 100,000 in cash and books worth Rs 200,000 to the Buddhist and Pali University.

The aggregate qualifying payments that Mr. Kamal is entitled to subtract from his taxable income for the year of assessment 2018 is Rs 375,000, the full Rs 300,000 to Buddhist and Pali University (which is not subject to any cap and applies to both cash and non-cash donations), plus Rs 75,000 for his cash donation to the approved charitable institution (which is the lower value compared to 1/3 of his taxable income, or Rs 75,000, whichever is less). The donation of the furniture to the approved charitable institution is not a qualifying payment.

11.1.3 Basic relief

Resident individuals are entitled to a basic relief in the amount of Rs. 500,000 for each year of assessment, paragraph 2(a) of the Fifth Schedule to the Act. However, this does not apply to an individual in his capacity as a trustee, receiver, executor or liquidator. The relief may be deducted against the taxable income of an individual **except to the extent that the taxable income comprises gains from the realization of investment assets.**

Example 11.1.1.3-1

Mr. Anil has received Rs 400,000 of business income and Rs 600,000 of gain from the realization of a portfolio of unlisted shares that he has held as investment for the year of assessment 2018/19. Assume Mr. Anil has no any other income and is tax resident in Sri Lanka for that year of assessment.

Mr. Anil is entitled to apply the basic relief against his business income of Rs 400,000 but not against the investment gain of Rs 600,000. Accordingly, his taxable income will be Rs 600,000. The excess relief of Rs 100,000 will be disregarded.

11.1.4 Employment income relief

Resident individuals are entitled to an additional employment income relief in the amount of Rs 700,000 for each year of assessment, paragraph 2(b) of the Fifth Schedule to the Act. Unlike the basic relief which is available to resident individuals can be used to offset against all taxable income except gains from the realization of investment assets, the employment income relief is only available to resident individuals and can only be set off against employment income.

Example 11.1.1.4-1

Mr. Basil has received,
employment income Rs 800,000
business income Rs 200,000
investment income Rs 400,000 (comprising Rs 100,000 of gains from realization of investment assets and of dividends Rs 300,000)

for the year of assessment 2018/19. Assume Mr. Basil has no any other income and is tax resident in Sri Lanka for that year of assessment.

He is entitled to apply the basic relief against his employment income of Rs 800,000, business income of Rs 200,000 and dividends of Rs 300,000 and also entitled to apply the employment income relief against his employment income of Rs 800,000. He is not entitled to any relief in respect of the gains from realization of investment assets.

To maximize his relief, Mr. Basil will offset his Rs 500,000 basic relief in full against his business income (Rs 200,000) and dividends (Rs 300,000), and he can claim employment income relief of Rs 700,000 in full against his employment income (Rs 800,000), result in a taxable income of Rs 100,000 from employment and Rs 100,000 from realization of investment assets.

Example 11.1.1.4-2

Mr. Ananda has received Rs 1.5 million income from his employment for the year of assessment 2018/19. Assume Mr. Ananda has no any other income and is tax resident in Sri Lanka for that year of assessment.

Mr. Ananda is entitled to apply the full basic relief and the full employment income relief against his employment income, resulting in taxable income of Rs 300,000, (Rs 1.5 million less Rs 500,000 basic relief and Rs 700,000 employment income relief).

Example 11.1.1.4-3

Ms. Mala has received,
employment income Rs 600,000
business income Rs 500,000
investment income Rs 700,000 (comprising Rs 100,000 of interest income from of investment on treasury bills and of rent income Rs 600,000)

for the year of assessment 2018/19. Assume Ms. Mala has no any other income and is tax resident in Sri Lanka for that year of assessment.

Ms. Mala is entitled to apply the basic relief against his employment income of Rs 600,000, business income of Rs 500,000 and investment income of Rs 700,000 and also entitled to apply the employment income relief against her employment income of Rs 600,000.

To maximize her relief, Ms. Mala will offset her Rs 500,000 basic relief in full against his business income (Rs 500,000) and investment income (Rs 700,000), however she is not entitled to claim the employment income relief of Rs 700,000 in full, since her employment income is Rs 600,000. Therefore, she can claim only Rs 600,000 which is the maximum of employment income relief, result in a taxable income of Rs 700,000 (from her business income and investment income).

11.1.5 Rental income relief

Resident individuals who derive investment rental income are entitled to a rental income relief in the amount of 25% of the total rental income for each year of assessment, under paragraph 2(c) of the Fifth Schedule to the Act. This relief is available only where the resident individual does not claim any actual expenditure for repair, maintenance and depreciation of the investment asset.

Example 11. 1.1.5-1

Mr. Gayan owns Company A which is in the business of office space rental. Company A derives business rental income of Rs 4 million. In addition, Mr. Gayan has inherited a residential property from his late father, which he does not use as his principal residence but instead rents it out for Rs 1 million for a year. Assume that he has not claimed deductions for actual expenditure for repair, maintenance and depreciation of the residential property.

He is entitled to apply the full Rs 500,000 basic relief as well as the full rental income relief of Rs 250,000 (25% of Rs 1 million) against his investment rental income, resulting in taxable income of Rs 250,000 from the investment rental income.

Company A will not be entitled to the rental relief as it is an entity and not an individual, and because of the reason that, the office buildings are held as business assets and not as investment assets. However, Company A is entitled to claim deductions for any actual expenditure for repair and improvements of the office building under S. 14 and depreciation allowances under S. 16.

11.1.6 Senior citizen interest relief

Interest paid to a resident individual is a final withholding payment, under S. 88(1)(b). As such, the basic relief is not available against such interest income, (S. 3(2)). However, senior citizens (defined in S. 195) are entitled to a relief up to Rs 1.5 million for each year of assessment in respect of interest income derived from a financial institution.

In this regard, bank/financial institutions should not withhold tax on interest paid to senior citizens to the extent that the relief threshold has not been exceeded and the bank/financial institution can rely on a declaration made by an account holder that is a senior citizen in such form as may be prescribed. For each and every account the declaration should be provided.

There are three main scenarios to the declaration that can be made by a senior citizen who holds accounts in banks/financial institutions. In the first scenario, a senior citizen account holder declares that he or she has interest income on the account(s) with financial institutions, does not exceed the relief of Rs 1.5 million. In such a case, the primary financial institution will rely on the declaration in determining its withholding obligations.

Example 11.1.1.6-1

Mr. Ananda is a senior citizen in the year of assessment 2018/19 and he holds savings account and a fixed deposit account with Bank A. He will be receiving Rs 1 million interest income from the fixed deposit and Rs 500,000 million interest income from the savings account (Rs 1.5 million interest incomes) with Bank A in the year of assessment 2018/19. Mr. Ananda has no accounts with any other financial institutions, and he provides a declaration to Bank A informing that his interest income for the Y/A 2018/19 does not exceed Rs 1.5 million.

Bank A will rely on Mr. Ananda's declaration, not to withhold tax on the Rs 1.5 million of interest paid by Bank A to Mr. Ananda in the year of assessment 2018/19.

In the second scenario, a senior citizen account holder declares that he or she has interest income on the account(s) with financial institutions, exceeds the relief of Rs 1.5 million and to deduct withholding tax on excess amount of Rs 1.5 million. In such a case, the financial institution will rely on the declaration and should deduct withholding tax on the amount declared in the declaration.

In the third scenario, a senior citizen account holder declares that he or she has availed in respect of the interest receivable from the monies deposited with other accounts and therefore, to deduct withholding tax on the total interest income of the account. In such a case, the financial institution will rely on the declaration and should deduct withholding tax on the total amount of the interest income derived from the account.

Example 11.1.1.6-2

Mr. Silva is a senior citizen in the year of assessment 2018/19 and he holds savings account and a fixed deposit account with Bank A and Bank B. He will be receiving Rs 1.5 million interest income from the fixed deposit and Rs 500,000 interest income from the savings account (Rs 2 million interest incomes) with Bank A. Mr. Silva receives Rs 250,000 of interest from the savings account with Bank B.

He should provide declaration to bank A under the second scenario, on the amount of Rs 500,000 which is in excess of relief Rs 1.5 million rupees to deduct withholding tax in the year of assessment 2018/19.

Further, he should provide a declaration to Bank B, to deduct withholding tax on total interest of Rs 250,000, since he has enjoyed the full relief of Rs 1.5 Million on the interest income of other accounts. Therefore, withholding tax should be withheld for the year of assessment 2018/19.

Further, individuals cannot subsequently claim a refund from the IRD for any tax withheld by any of the banks/ financial institution as a result of improper designation and declaration.

If, after providing a declaration to a financial institution as not to deduct withholding tax for a year of assessment, a senior citizen discovers that he or she has received or will be receiving total interest of more than Rs 1.5 million from all the accounts holding in financial institutions, the senior citizen should immediately provide correct declaration to the financial institution.

In addition to that, the senior citizen must also revise the declaration to the withholding financial institution to reflect any change in the unutilized relief amount as a result of the change in the composition of non-withholding financial institutions.

11.2 Partnerships

"partnership" is an association of two or more individuals or corporations carrying on business jointly for the purpose of making profit, irrespective of whether the association is recorded in writing; s. 195.

The partners must have separate legal personalities; however, there is no requirement for such an association to be in writing. It could be oral or even inferred from conduct, depending on the facts of the case. Where two or more independent parties co-operate in business either on a continuing basis or for an isolated project or venture, it is important to determine whether the co-operation between the parties creates a separate entity and, if so, what type of entity is created. If no entity is created, the parties will continue to conduct their independent business and any activities involved in the co-operation must be apportioned between the parties and attributed to their independent businesses. But in some cases, the activities will be sufficient to create a partnership as defined in s. 195.

In this case the partnership is treated as a person for the purposes of the Act and will have to calculate its income separately from the income of the parties who have become its partners. So, it is important to determine whether a partnership is created or whether activities of independent parties simply amount to co-operation.
In principle a partnership involves two or more persons conducting a business jointly. The partners conduct the business on behalf of each other.

If the parties merely agree to co-operate to achieve a particular business project or objective, they do not intend to conduct business on behalf of each other and continue to conduct business on their own behalf.

Important factors in distinguishing mere co-operation from a partnership:

- Co-operating parties continue to conduct their businesses independently of each other, i.e. they do not conduct business jointly or on behalf of each other.
- The term of co-operation is limited, it is to achieve a particular business project or objective and there is no intention for a continuing relationship. By contrast, a partnership forms the basis of cooperation on many projects.
- Contributions by co-operating parties to the project are often in-kind in the form of labour or assets that are provided to the project in the ordinary course of the party's own business.
- The profit to be derived from the project is not in a fixed proportion between the co-operating parties but may vary depending on how each party performs their responsibilities under the project.

Example 11.2.1

Company A runs an earthmoving business. Company B runs an engineering business. They sign an agreement with the Government to build a 50km highway. They also sign a co-operation agreement setting out the terms under which each will provide labour and machinery to the project and how they will divide the profits. The term of the co-operation is just for the duration of the highway project, projected to be 3 years. The agreement preserves the right of the parties to continue to conduct their independent businesses in the normal way.

Company A and Company B are not partners. They have not agreed to conduct a business jointly. They have merely agreed to cooperate with each other on this particular project. They each continue to run their own businesses and, for each of them, this project is merely part of those independent businesses. Their co-operation is not recognized as an entity under the Act.

In some cases, independent parties will formalize their co-operation through the creation of a separate legal entity such as a company. The parties will hold shares in the entity and the entity will continue for the duration of the co-operation and afterwards may be liquidated. This type of arrangement is commonly called a "joint venture", particularly where it involves co-operation between both foreign and domestic parties. As a company under the Act, such a joint venture must calculate its income separately from those of its joint venture participators.

As defined in s. 195, a partnership in which at least 20 of the partners have limited liability for the debts of the partnership is specifically deemed to be a company for the purposes of the Act,

All the business activities of a partnership are treated as conducted in the course of a single partnership business, s. 53(6). While a partnership exists to carry on business for the purpose of making profits, it does not preclude the possibility of a partnership owning investment assets where such assets are not related to the business activities. Assets owned and liabilities owed by partners in common are treated as owned or owed by the partnership and not by the partners, s. 53(5).

Example 11.2.2

Mr. A, Mr. B and Company C have entered into a partnership to jointly carry out a retail business, with their partnership interests being 25%, 25% and 50% respectively. In the course of setting up the retail business, Mr. A, Mr B and Company C comes across a commercial space which is selling for a very low price, but due to the location of the commercial space, is not suitable for their retail business. Mr. A, Mr. B and Company C nevertheless decided to purchase the commercial space and own it in common. The commercial space is rented out to a third party for rental income. The commercial space is held as an investment asset by the partnership.

A partnership in and of itself does not have a separate legal personality. However, for income tax purposes, a partnership is treated as an "entity" but will not be assessed to tax on its taxable income (other than on gains from the realization of investment assets). A partnership's income from its business and investments for a year of assessment will form the partnership income of the partnership for the year, s. 54(1). Similarly, a partnership's loss from its business and investments for a year of assessment will form the partnership loss of the partnership for the year, s. 54(2).

A partnership is liable to pay tax on withholding payments and on gains from the realization of an investment asset but is not liable to pay tax on the rest of its taxable income, s. 53(1) and (2). What this means is that the partnership income of a partnership (other than gains from the realization of an investment asset of the partnership) will be allocated proportionally to the partners, who are liable to pay tax on their proportionate share of partnership income at their respective personal or corporate tax rate, ss. 53(3) and 55(3)(c).

Gains from the realization of an investment asset of the partnership will be taxed in the hands of the partnership as an entity at 10%. Each partner in a partnership is responsible for filing a return of capital gains under s. 93(3) for the gains derived from the realization of the partnership's investment asset, as well as paying tax on that gain, s. 96(2). Any one of the partners of the partnership can discharge these duties, but all the partners will be jointly and severally liable for non-compliance with any of these obligations, s. 96(4).

As a general rule, a partnership can enter into arrangements with its partners and such arrangements will be recognized for tax purposes, s.53 (7). However, the Act specifically identifies two types of arrangements between a partnership and its partners which will not be recognized.

These are:

(a) loans made by partners to a partnership and any interest paid under such loans; and

(b) services provided by a partner to a partnership (whether as an independent contractor or an employee).

In such cases, the loan or service (as the case may be) would be treated as a contribution made by a partner to the partnership and would be relevant in determining the share of that partner in the partnership, s. 53(7). This is to prevent partnerships from disguising partnership distributions to partners as interest, service fee or wages.

Under general law, a partnership ceases to exist once there is a change in the composition of its partners. Section 53(8) deems a partnership to continue to exist even if there is a change in the composition of partners, as long as at least two of the existing partners continue to exist.

Taxation of Partners

As discussed above, the partners of a partnership are required to account for tax on their respective proportionate share of partnership income. The share of partnership income of a partner is determined based on the partner's percentage interest in any income of the partnership as set out in the partnership arrangement, s. 55(5). The proportionate share of partnership income or partnership loss allocated to each partner retains its character as to type and source, s. 55(3)(a). Such partnership income or partnership loss is deemed to be derived or incurred (as the case may be) at the end of the partnership's year of assessment, s. 55(3)(b).

Example 11.2.3

Mr. A and Company B are equal partners in a partnership. For the year of assessment 2018/2019, the partnership has business income of Rs. 2 million and rent income of Rs. 500,000 received from Mr. P s. 54(1). Each of Mr A and company B will be deemed to have derived Rs. 1,250,000 from the partnership on 31 March 2019 and will therefore form part of the taxable income of Mr. A and company B for the year of assessment 2018/2019. Partnership has deducted 8% WHT from the partnership income and paid to the Department.

Business income of the partnership	*= Rs. 2,000,000*
Investment income of the partnership	*= Rs. 500,000*
Partnership income	*Rs. 2,500,000*
8% WHT on partnership income	*= Rs. 2,500,000*8%*
	= Rs. 200,000
Partnership share of Mr. A	*=Rs. 1,250,000*
Partnership share of company B	*=Rs. 1,250,000*

Tax payable by Mr. A

Partnership share of Mr. A		*=*	*1,250,000*		
Less: Allowance		*=*	*(500,000)*		
Tax payable on		*=*	*750,000*		
@ the rate of 4%		*=*	*(600,000)*	*=*	*Rs. 24,000*
@ the rate of 8%		*=*	*150,000*	*=*	*Rs. 12,000*
Total tax				*=*	*Rs. 36,000*
Less: WHT credit	*1,250,000*8%*			*=*	*Rs. 100,000*
Refundable				*=*	*Rs. 64,000*

Tax payable by company B

Partnership share of company B	=	*Rs. 1,250,000*
Tax payable	=	*Rs. 1,250,000 * 28%*
	=	*Rs. 350,000*
Less: WHT credit	=	*Rs. 100,000*
Balance tax payable	=	*Rs. 150,000*

The partners (and not the partnership) are liable to pay tax with respect to the taxable income of the partnership.

However, each partner's share of the partnership income is subject to partnership withholding tax at the rate of 8% which becomes creditable to the partners against their ultimate tax liability on that partnership income. The withholding tax does not apply to any share of partnership income that includes a gain from the realization of an investment asset in respect of which tax is payable on assessment by the partnership, s. 53(9).

The proportionate share of partnership income or partnership loss allocated to each partner also retains its character as to type and source, s. 55(3)(a). It is the precedent partner of a partnership who is generally responsible for withholding tax on each partner's share of any partnership income, s. 53(9). Where there is no such partner in Sri Lanka, an agent of the partnership in Sri Lanka will be held responsible for withholding. To the extent that tax has been withheld by the partnership with respect to the partnership income allocated to the partners, a proportion of such tax withheld will be allocated to each partner proportionately to each partner's share and treated as paid by the partner, s. 55(4).

In addition to tax on partnership income, partners are also required to pay tax on any gains on disposal of interest of a partner in a partnership. Such gains are treated as income from business in the hands of the partner, s. 55, and are to be computed in accordance with Chapter iv but subject to special computational adjustments under s. 56.

11.3 TRUST

A trust is a way of managing assets (money, investments, land or buildings) for people and are set up for a number of reasons, including:

- to control and protect family assets
- when someone's too young to handle their affairs
- when someone cannot handle their affairs because they're incapacitated
- to pass on assets while person is still alive
- to pass on assets when person die (a 'will trust')
- under the rules of inheritance if someone dies without a will

Trusts involve:

- **Settlor**

The person who puts assets into a trust and decides how the assets in a trust should be used called settlor- this is usually set out in a document named the 'trust deed'. Sometimes the settlor can also benefit from the assets in a trust - this is called a 'settlor-interested' trust.

- **Trustees**

The person who manages the trust called trustee and are the legal owners of the assets held in a trust. Their role is to:

- deal with the assets according to the settlor's wishes, as set out in the trust deed or their will
- manage the trust on a day-to-day basis and pay any tax due
- decide how to invest or use the trust's assets

If the trustees change, the trust can still continue, but there always has to be at least one trustee.

- **Beneficiaries**

Beneficiaries are the persons that get the benefits from the trust. There might be more than one beneficiary, like a whole family or defined group of people. They may benefit from:

- the income of a trust only, for example from renting out a house held in a trust
- the capital only, for example getting shares held in a trust when they reach a certain age
- both the income and capital of the trust

Taxation of Trusts and their Beneficiaries

Trusts

Trust and trustees of the trust defines in the act

"trust" means an arrangement under which a trustee holds assets;

"trustee" means an individual of 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 assets are 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 or of a court of by other operation of the law; and

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(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;

3.4.1: Taxation of trusts

A trust does not have a separate legal personality. Under general law, the assets of a trust are legally held by the trustee. Therefore, for the purposes of this Act, a trust is treated as an "entity", and each trust is treated as a separate person even if they may have the same trustee, s. 57(5).

According to the general rule, the trust will be assessed to tax on its taxable income as an entity separately from its beneficiaries, where no any entitlements provided under the trust deed. However, if the entitlements exist under the trust deed, that amounts should be treated as an expense incurred by the trust and on the other hand income for the beneficiaries. Then the entitlements shall be taxed separately in the hands of the beneficiaries. Simply trusts are not subject to double taxation, either principal or income on which the trust paid taxes can be distributed tax-free to the beneficiaries. Likewise, any taxable distribution to beneficiaries is deductible by the trust.

Taxation of beneficiaries

A beneficiary is only liable to tax on trust income (other than gains from the realization of an investment asset, s. 57(3)(b)) that the beneficiary is presently entitled to (i.e. has a vested and indefeasible interest in the income and an immediate right to demand payment of the income, s. 57(3)(a)) for the year of assessment of the trust ending on the last day of or during the year of assessment of the beneficiary ("relevant trust year"), s. 57(2), and in such a situation, tax transparency treatment is accorded so that:

(a) each amount derived and expenditure incurred by the trust or trustee (in such capacity) are treated as derived and incurred by the beneficiary (not the trust or trustee) at the end of the trust's year of assessment;

(b) each amount and expenditure retain its character as to type and source;

(c) each amount and expenditure are allocated proportionally to each beneficiary's share, including tax paid under the Act or foreign income tax paid or treated as paid by the trust with respect to the trust income allocated.

Example

Miss Karuna and Miss Muditha are twin sisters and young beneficiaries to a non-revocable trust set up by their father, Mr Meththananda. The trust is to be managed by a professional trustee, Ms Upeksha, who is paid an annual fee out of the income of the trust. Under the trust deed, the trust assets comprise three large tracts of farm land which are rented out to farmers (thus deriving rental income). The lands are to be held and managed by the trustee for the benefit of the beneficiaries for the rest of their lives, the income and proceeds from which are to be used only for educational and health purposes. Each of Miss Karuna and Miss Muditha has the right to demand payment of up to LKR 1 million of rental income from the trust upon attaining 21 years of age. Miss Karuna and Miss Muditha will turn 21 years old on 1 July 2018. The trust has a year of assessment ending 31 March 2019.

Miss Karuna and Miss Muditha will each be considered to be presently entitled to LKR 1 million of trust income on 1 July 2018. To determine the relevant trust year, first determine the year of assessment of beneficiary, which would be 2019 (for the period from 1 April 2018 to 31 March 2019). The relevant trust year is the year of assessment of the trust ending on the last day of (31 March 2019) or during the year of assessment of the beneficiary (anytime from 1 April 2018 to 31 March 2019). Miss Karuna and Miss Muditha are therefore each liable to tax on their respective share of rental income of the trust for the year of assessment 2018/2019 of the trust. Assume that the total rental income of the trust for the year of assessment 2018/2019 is LKR 4 million, and that the aggregate deductions available to the trust on its income (including trustee fee payable to Ms Upeka) is LKR 1 million, the tax liability of each of Miss Karuna and Miss Muditha and the trust for the year of assessment 2018/2019 of the trust is as follows:

Person	*Rental income*	*Deductions*	*Taxable income*
Karuna (individual)	*1 million*	*250,000*	*750,000*
Muditha (individual)	*1 million*	*250,000*	*750,000*
Trust (entity)	*2 million*	*500,000*	*1.5 million*

Note that Ms Upeka will have to account for tax on the trustee fee separately as income from business in her own personal capacity.

As mentioned, the general rule (where no present entitlement exists) is that a trust is taxed as an entity. The only exception to this is a trust of an incapacitated individual that is not a minor. In such cases, the trust will be taxed as though it is **an individual**, s. 57(1)(a).

Taxation of Non-Resident Trust

Since a trust is regarded as an "entity" for tax purposes, a resident trust that does not have presently entitled beneficiaries will be subject to tax on its worldwide income, and therefore, it is only fair that any distributions that are made to its beneficiaries are not subject to further tax to avoid double taxation on the same income, s. 58(1)(a). However, where a trust is a non-resident, it is only subject to tax on its Sri Lanka-sourced income, and it would be necessary for a beneficiary of a non-resident trust to include any distributions of such trust in calculating the beneficiary's income to the extent that the underlying trust income out of which the distribution is paid has not been subject to tax in the hands of the trust, trustee or beneficiaries in Sri Lanka under s. 57(1) and (2), s. 58(1)(b). See s. 69(3) on determining the tax residency of a trust and s. 71 on determining the source of income.

Section 58(2) requires any gains from the disposal of interest of a beneficiary in a trust to be included in calculating the income of beneficiary.

Example

Mr Z is the sole beneficiary of Trust A, a non-resident trust. The assets of Trust A comprise industrial land in Sri Lanka which is rented to a local company, and a savings account in India. On 31 December 2018, Trust A makes a distribution to Mr Z. Mr Z is required to include such amount of distribution in calculating his income for the year of assessment 2019, s. 7(3)(f). However, Mr Z will be entitled to claim a credit in respect of the tax already withheld on the rental income from the land in Sri Lanka.

Mr Z subsequently enters into an arrangement with Mr B in April 2019, under which he assigns all his rights to trust distributions to Mr B for a consideration. Any gain derived by Mr Z from this assignment (i.e. consideration less any costs, e.g. legal fees) must be included in calculating Mr Z's income for the year of assessment 2020.

11.4 UNIT TRUST

By using the general trust concept, unit trusts become vehicles for investors to pool their funds for investment purposes. Each investor purchases a number of units in the trust, or 'fund'. The return to the investor comprises regular distributions based on the number of units owned. The distribution usually comprises income only, but it may include capital gains. Because such trusts, or funds, are taking monies from the public for investment, they are highly regulated by the authorities, in particular the Securities Commission and central Bank. A unit trust is established by a trust deed. An approved custodian trustee is appointed to hold the investments on behalf of investors, and an approved management company is appointed to manage the funds in accordance with the aims and parameters set for the fund. Units in the fund can be bought and sold at the prices determined and published by the managers.

Taxation of unit trusts

Carrying out an "eligible investment business"

According to the s.195 ***"eligible investment business" means*** *a business or investment comprising* ***predominately*** *of owning, investing or trading in –*

(a) capital assets;

(b) financial instruments; or

(c) other similar assets;

"predominantly" means 80% or more, calculated based on gross income.",

Unit trusts that conduct eligible investment business will be treated as "pass through vehicles" and tax will be payable by the unitholders rather than by the unit trust itself (see section 57(2)), with the exemption of the tax payable on gains from the realization of investment assets (which would be NIL for listed shares). This "pass through" treatment arises because unitholders have fixed entitlements to the income of the unit trust corresponding to their unitholding.

The income could be received as a distribution or redemption entitlement. Individual unit holders pay tax on their share of the income that they are legally entitled to from the unit trust, irrespective of how that entitlement arises (e.g. as pro rata entitlement or as an allocated redemption amount). The actual distribution (whether as part of a redemption payment or not) is already exempt to avoid double taxation as unitholders are already liable to tax on their share of the unit trust's income. If received as a redemption entitlement that portion which represents income of the trust will be treated as such under the IRA, with a corresponding reduction when calculating the gain or loss on the unit holding itself in order to also ensure there is no double taxation s.38(3).

Further, each amount of income to which a unit holder becomes entitled to (whether as part of a redemption payment or not) will be treated as follows under the s. 57(2):

- each amount derived by the trust or trustee (in such capacity) is treated as derived and incurred by the beneficiary (not the trust or trustee);
- each amount retains its character as to type and source;
- each amount is allocated proportionally to each beneficiary's share, including tax paid under the Act or foreign income tax paid or treated as paid by the trust with respect to the trust income allocated.

Example:

A unit trust has 2 unit holders each holding 50 units. Unit holder 1 consists of an individual, Mr.Siripala. Unit holder 2 consists of a company, Company kalu Ltd. Each are entitled to a fixed 50% share of the income of the unit trust because each unit holder holds 50% of the total units on issue in that trust. The unit trust holds one investment asset, being fixed deposit in a financial institution.

In the year ended 31 March 2019, the unit trust derived Rs. 2,000,000 of interest income from the FD (which suffered withholding tax at 5%). Each unit holder receives their share of the income (being, Rs. 1,000,000 comprising 50% of the interest income) entirely as a redemption payment.

The tax position of the trust and each unit holder can be summarized as follows:

- *No further tax is payable at the unit trust level on the basis that it is a "pass through vehicle".*
- *The Rs. 1,000,000 received as a redemption amount will continue to be treated as interest income in the hands of Mr. Siripala. As such, Mr. Siripala will be deemed to have paid the 5% withholding tax and the amount will not be subject to any further taxation (i.e. the withholding tax is final for an individual unitholder). The consideration received for the units on redemption will be reduced to NIL (assuming no capital is returned). Therefore, there will be no gain or loss on the redemption of the units in the hands of Mr.Siripala attributable to the income amount.*
- *The Rs. 1,000,000 received as a redemption amount will also continue to be treated as interest income in the hands of Company Kalu Ltd. As such, Kalu Ltd will be deemed to have paid the 5% withholding tax but the amount will be subject to further taxation, with credit. However, the consideration received for the units on redemption will similarly be reduced to NIL (assuming no capital is returned). Therefore, there will be no further gain or loss on the redemption of the units in the hands of Kalu Ltd attributable to the income amount.*

Unit trust Not carrying out an "eligible investment business"

unit trust deem to be a resident company for tax purposes unless it is carrying out an "eligible investment business" (i.e. a business or investment comprising predominately of owning, investing or trading in capital assets, financial instruments or other similar assets)s.59(1). In other words, if a unit trust is carrying out an eligible investment business, the general tax treatment of trust will apply. However, if a unit is not carrying out an eligible investment business, the general tax treatment of trust will not apply, s. 59(4), and the trust will be treated like a resident company instead, so that a unit, unitholder and distribution of the unit trust will be treated as a share, shareholder and dividend of the company, respectively. This means that the unit trust must withhold tax at 14% on all distributions to its unitholders, s. 84(1)(a)(i) and paragraph 8(1)(b)(ii) of the First Schedule.

Moreover, management and trustee fees paid will be deemed to be expenses incurred by the company in the production of its income, s. 59(3).

11.5 Companies

11.5.1 General

A company has separate legal personality and will be treated as a taxpayer separate from its shareholders. Note that the definition of "company" in S. 195 is extremely broad and, importantly, does not require incorporation as a condition to qualify as one.

According to the Section 195 (1) the “company" -

(a) means a corporation, unincorporated association or other body of persons;

(*b*) includes –

(i) a friendly society, building society, pension fund, provident fund, retirement fund, superannuation fund or similar fund or society; and

(ii) a government excluding the Sri Lankan government, a political sub-division of a government, or a public international organization; but

(b) excludes a partnership or trust; and

(*d*) the following shall be deemed to be a company: -

(i) a partnership in which at least twenty of the partners have limited liability for the debts of the partnership; and

(ii) a unit trust or mutual fund to which section 59 applies;

The practical implication of this is that almost all distributions from artificial persons (other than partnerships and trusts, paragraph (1)(c) of the definition will be treated as dividends for tax purposes and therefore subject to withholding. See 11.*5.2* below on the treatment of dividends.

11.5.2 Dividends

Distributions are a special feature of artificial persons. They constitute a payment by an entity to a person holding a "membership interest" in the entity. "Membership interest " is defined in S.195 and was discussed above at 11.*1.3*.

"Dividends" of entities are included in calculating the investment income of a person, S. 7(2)(a). Dividends are distributions of a company but given the extremely broad definition of "company" which essentially covers all types of artificial persons other than partnerships and trusts, most distributions of entities are "dividends" for the purposes of S. 7(2)(a) [including distributions by a partnership where 20 or more of the partners have limited liability for the debts of the partnership, S. 195].

"Dividend" is defined in S. 195 very broadly in terms of a payment derived by a member from a company, paragraph (a) of the definition of "dividend" in S. 195. The concept of "payment" imports a broad meaning as defined in S. 195 and discussed above at 2.*4.1.* and so, the concept of "dividend" covers all types of in-kind payments and constructive distributions. Also included in the concept of "dividend" is a capitalization of profits by a company, whether by way of a bonus share issue, increase in the amount paid-up on shares or otherwise, and regardless of whether such amount is distributed or not. Capitalizations are further discussed in the context of bonus shares at 11.*5.3*.

However, the amount of "dividend" is reduced by any 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, paragraph (c) of definition of "dividend" in S. 195.

Example 11.5.2-1

Bank A is a Company with various offices in Sri Lanka. It employs Mr. Shan and he holds a small number of shares in Bank A. During year 1 Bank A pays Mr. Shan's wages into a bank account that Mr. Shan holds with the Bank. Bank A credits Mr. Shan with interest on this account. Also during year 1 Mr. Shan decides to buy a house and takes out a home loan with Bank A on the usual terms offered to the public.

On settlement of the home contract, Bank A pays the amount of the loan to the seller of the home on Mr. Shan's behalf. Towards the end of year 1 Mr. Shan receives a dividend on the shares he holds in Bank A.

Each of the wages, interest received, loan funds and dividend are not "dividend" by virtue paragraph (c) of the definition of "dividend" in S. 195, even though they fall within the broad general definition in paragraph (a) of the definition of "dividend" in S.195.

The wages are excluded because they are included in Mr. Shan's income from employment within S. 5(2) (a), and under paragraph (c) (iii) of the definition of "dividend" in S.195. The interest on the bank deposit is excluded because it is a final withholding payment within S. 88(1)(b), and under paragraph (c) (iii) of the definition of "dividend" in S. 195. The loan funds are a payment to Mr. Shan because they reduce a liability of Mr. Shan's to the seller of the house.

However, Mr. Shan makes an equal payment to the bank for these funds in the form of the debt claim against Mr. Shan with respect to the loan funds and the promise to pay interest on the loan. Accordingly, the provision of the loan funds by the bank is not a dividend, paragraph (c)(i) of the definition of "dividend" in S.195.

The payment of the dividend does not fall within any of the exclusions in paragraph (c) of the definition of "dividend" in S. 195. The dividend is a final withholding payment, under S. 88(1)(a), but the only reason why it is a final withholding payment is because it is a dividend.

A payment (or part thereof) by a company to its members could be a return of capital, which would be excluded from the definition of "dividend" as it would be a payment debited to a capital account, under paragraph (c)(ii) of the definition of "dividend" in S.195.

The difficulty lies in determining when a payment could be said to be a return of capital. Subject to any rules and restrictions in relation to the sharing of profits and return of capital under company law, the IRD will generally accept a company's characterization of a payment to its members as a return of capital for tax purposes, if such payment reduces the net value of the entity's assets below

capital contributions previously made to the entity (that have not been repaid). The IRD will disallow such characterization where the IRD considers it to be an attempt to avoid tax payable by its members on dividends and will instead treat such payment as a dividend on which tax must be paid.

All dividends distributed by a resident company (other than those paid to another resident company) are taxed by way of final withholding tax, S. 61(1)(a). Distributions of trusts and partnerships are not subject to final withholding tax. Dividends distributed by a non-resident company must be included in calculating the income of the members, S. 61(1)(b).

11.5.3 Bonus Shares

When a company issues bonus shares the existing shareholders in the company receive extra shares. The company pays up the par or nominal value of the shares (and any premium) by transferring an amount from the company's retained profits to the company's share capital account.

However, an issue of bonus shares does not result in a reduction in the value of the company. Nevertheless, the issue of bonus shares as capitalization of profits is specifically treated as a dividend regardless of whether an amount is distributed or not, paragraph (b) of definition of "dividend" in S. 195 and so results in a dividend equal to the paid-up value of the bonus shares. When paid by a resident company, this amount may constitute a final withholding payment and subject to a 14% withholding tax, S. 61(1)(a), 88(1)(a) and First Schedule. When paid by a non-resident company, this amount must be included in calculating the income of the shareholders, S. 61(1)(b).

IRD will generally accept that the amount of the final withholding payment qualifies as costs of the shareholder with respect to the acquisition of the bonus shares. However, the issue of bonus shares potentially causes a reduction in the value of the existing shares. In this situation, in order for the final withholding payment to qualify as costs, the IRD requires that those costs and the costs for the existing shares are spread evenly across the bonus shares and the existing shares. If the bonus shares are of a different class to the original shares, the spreading must be proportionate to the market values of the different classes.

Example 11.5.3-1

Mr Asiri owns 100 shares in Company Z which is a resident company in Sri Lanka and he paid Rs. 500 per share. Company Z capitalizes profits and he receives in respect of his shareholding a further 20 shares with a paid-up value of Rs. 300 per share as bonus shares. Company Z is treated as distributing a dividend equal to the capitalized amount of the bonus shares, therefore, Rs. 300 per share, and will be liable to account for final withholding tax at the rate of 14% on this amount.

Mr. Asiri has costs with respect to his existing shareholding of Rs. 500 per share. The IRD accepts that he has costs of a further Rs. 300 per bonus share but requires Mr. Asiri to spread this amount and the costs of the existing shareholding evenly across the entire shareholding after the issue of the bonus shares.

In order to do this, he must calculate his costs of his entire shareholding. That is Rs. 56,000 (Rs. 50,000 + Rs. 6,000). He must divide this amount by the number of shares which are he holds now (number of shares 120). This gives adjusted cost of Rs. 467 per share. Therefore, if Mr. Asiri subsequently sells 10 shares for Rs. 5,500 he will realize a gain on disposal of Rs. 830 (Rs. 5,500 less LKR 4,670) irrespective of whether Mr. Asiri sells part of his original shareholding or part of his bonus shareholding.

11.5.4 Tax Rates

For any year of assessment commencing on or after April 1, 2018, the taxable income of a company shall be taxed at the following rates:

(a) in the case of a Small and Medium Enterprises – 14%;
(b) in the case of a company predominantly conducting a business of exporting goods and services – 14%;
(c) in the case of a company predominantly conducting an agricultural business – 14%;
(d) in the case of a company with income from a business consisting of betting and gaming, liquor and/or tobacco (excluding such income which is merely incidental to another business) – 40%;
(e) in the case of a company predominantly providing educational services – 14%
(f) in the case of a company predominantly engaged in an undertaking for the promotion of tourism- 14%; and
(g) in the case of a company predominantly providing information technology services – 14% Where a company's taxable income includes gains from the realisation of investment assets then –

(a) those gains, shall be taxed to the company at the rate of 10%; and
(b) only the remainder of the company's taxable income shall be taxed at the rate referred to the above business sectors.

11.5.5 Definitions

As defined in the First Schedule-

i. providing information technology means –
   (a) software development services; or
   (b) the provision of information technology services under a business process outsourcing arrangement or a knowledge process outsourcing arrangement;
ii. undertaking for the promotion of tourism means an undertaking for the operation of-
   (a) any hotel or guest house approved by the Ceylon Tourist Board;
   (b) any restaurant graded by the Ceylon Tourist Board as being in "Class A" or "Class B";
   (c) any business of travel agent who provides travel management services for domestic travel in Sri Lanka;
   (d) any business of transporting tourists only; or
   (e) any business approved by the Ceylon Tourist Board for providing facilities for recreation or sports;
iii. "predominantly" means 80% or more calculated based on gross income

As defined in S. 195 –

"Small and Medium Enterprise" means a person who satisfies the following conditions:-

(a) the person who conducts business solely in Sri Lanka other than an individual who is engaged in providing professional services individually or in partnership being an individual who is professionally qualified;
(b) the person does not have an associate that is an entity; and
(c) the person's annual gross turnover is less than Rs. 500,000,000;

11.5.6 Specified Undertaking

As per S.195 "export" includes specified undertaking, Therefore, the concessionary rate of 14% is applicable for the specified undertaking.

Further, as defined in S.195 "specified undertaking" means an undertaking which is engaged in –

(a) entrepot trade involving import, minor processing and re-export;
(b) 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;
(c) providing front end services to clients abroad;
(d) headquarters operations of leading buyers for management of financial supply chain and billing operations;
(e) logistic services such as bonded warehouse or multi-country consolidation in Sri Lanka;

(f) transhipment operations;
(g) freight forwarding;
(h) supply of services 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 manufacture of such goods or provision of such services 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 for such services are made by such exporter or foreign principal to such person in Sri Lanka in foreign currency;
(i) production or manufacture, and supply to an exporter of non-traditional goods;
(j) the performance of any service of ship repair, ship breaking repair and refurbishment of marine cargo containers, provision of computer software, computer programmes, computer systems or recording computer data, or such other services as may be specified by the Minister by notice published in the Gazette, for payment on foreign currency;
(k) sale for foreign currency, of any gem or jewellery, being a sale made in Sri Lanka by

any person authorized by the Central Bank of Sri Lanka to accept payment for such sale in foreign currency;

11.6 Bank and Financial Institutions

Person's activities in conducting a banking business is treated as a **business separate from any other activity** of the person and the **income or loss** from such business for a year of assessment should be **calculated separately** (S. 66).

"Banking business" means the **banking business** of a Financial Institution. {S.66 (3)}.
As per Section 195 of the Act,

"Financial Institution" means –

(a) any company or body of persons carrying on **banking business** and includes a licensed specialized bank, within the meaning of the Banking Act, No.30 of 1988;

(b) a non-banking financial institution regulated in the same way **as a bank** in paragraph(a); or

(c) any other category of person as may be prescribed.

Either section S.66(3) or 195 of the Act, has not defined the "banking business. "But the above two sections together are meant that provisions in the Act in relation to the banking business are applicable only on banking business of a financial institution. That means any activity of a financial institution does not falls within meaning of the "banking business". Further, if a person carries on banking business and at the same time any other business as well, as per section 66, profit and income from banking business should be calculated separately and so, such person become a financial institution only in respect of banking business.

The meaning of "banking business" should be understood in general terms. However, it can be highly relied on the following definition given in section 86 (interpretation section) of the Banking Act, No.30 of 1988.
"banking business "means the business of receiving funds from the public through the acceptance of money deposits payable upon demand by cheque, draft, order or otherwise, and the use of such funds either in whole or in part for advances, investments or any other operation either authorized by law or by "customary banking practice".

Provisions of the Act especially applicable to Financial Institutions.

1. Deductible amount of financial cost – Section 18

The limitation on deduction of financial cost as per section 18 is not applicable on Financial Institutions.

2. Deduction of bad debt and specific provision for debt claims.

As per the section 24(4), a person can deduct bad debt in calculating person's income at the time of write off such debt if such amount has been included in person's income calculated on accrual basis for any year of assessment.

But, this section is subject to section 66 of the Act.

The Section 66 is applicable on persons conducting banking business. It says that if a person conducting **banking business** makes specific provision for a debt claim in accordance with the directives made by Central Bank of Sri Lanka, a portion specified by Commissioner General from such specific provision can be deductible in calculating the profit from banking business.

Accordingly, the link given by section 24(4) to section 66 implies following matters in deducting specific provision for debt claim in respect of banking business.

i. The specific provision will consider the amounts which has not included in person's income calculated on accrual basis. That means person conducting banking business can deduct capital portion of the loan even if it is not included in person' income.

   It should also be mentioned here that specific provision for a debt claim in accordance with the directives made by Central Bank of Sri Lanka is made only on capital portion of the debt claim.

ii. However, direct bad debt writes off (not from the provision for bad debt) should be considered under sections 17, 26 and 39 (d).

3. Tax treatment on mortgage bonds and, finance lease and instalment sale agreements (S.31 and S. 49).

11.6.1 Mortgaged bonds.

Providing loans on mortgage bonds is one of the normal banking business transactions. Such loans are considered as securitized loans. So, tax treatment applies to loans is similarly applicable on such securitized loans also.

Realization of Assets

As per the section 49(1), where a person (debtor) grants a mortgage on an asset to secure a debt owed to another person (Bank), following tax treatment should be applied.

(a) The debtor shall not be treated as realization the asset mortgaged and shall be treated as still owing the asset. It only a liability for the debtor.

(b) For the Bank, it should not be treated as acquiring the asset but shall be treated as owing a secured debt.

Accordingly, no gain or loss from realization of assets should be calculated at the time of entering in to a mortgaged bond.

11.6.2 Finance Leases and Instalment Sale Agreements.

Application of Section 31

The Section 31 deals with the tax treatment on payments under instalment sale and finance lease. It treats instalment sales and finance lease as sales with debt financing. Therefore, a rental under such arrangements is characterized as payment of interest and repayment of capital under a blended loan using interest compounded six-monthly or such other period as the Commissioner General may specify.

Accordingly, the following formula should be used for the calculation of interest component.

However, considering the industry practice, the Commissioner General may specify to compound interest annually.

As per the section 31, interest component is a business receipt for lessor or seller as the case may be. The remaining part is a capital recovery which reduces the debt claim against the lessee or purchaser. The receipt of last instalments will cause the disposal of this debt claim for no gain or loss as the total of the capital recoveries is equal to the amount of debt claim.

In the case of lessee or buyer, payment of interest may be a tax deduction subject to the conditions imposed by section 12 and 18. Further, the payer has the liability to deduct withholding on such interest payment as relevant.

The capital portion of the payments constitutes a cost on repayment of the debt liability which was incurred to acquire an asset. So, such repayment becomes a capital nature expense which is not deductible under section 11(2).

The payment of last instalment will cause the disposal of this debt liability for no gain or loss as the total of the capital repayments is equal to the amount of debt liability.

The meanings of blended loan, finance lease, instalment sale and lease term are given in section 31(6).

Application of Section 49

i. Application of section 49 in respect of finance lease agreement.

As per the section 49(2), where an asset is leased under a finance lease, the lessor shall be treated as transferring ownership of the asset to the lessee at the time of entering into the lease agreement. Hence, lessee is deemed to have acquired the asset at the beginning of the lease agreement.

Further, as per the Section 49(3)(b), the lessee is deemed to have acquired the asset at market value. If so, the market value of the asset should consist of capital portion of the lease loan and any other payment made by the lessee to the lessor (other than the interest portion of the lease loan) or any other seller in respect of such acquired asset. The market value of an asset should be applied on any buyer alike including a lessee.

As the ownership of the asset is deemed to be vested with the lessee, he can claim, subject to the other conditions specified in section 16, depreciation allowance on market value of the asset (depreciation allowance should not limit on the capital portion on the lease loan).

In the case of lessor, in terms of the section 49(3) says that he is treated as deriving an amount equal to the market value immediately before the transfer of the leased asset. Deriving an amount equal to the market value is realistic with regard to a lessor who is required to declare such market value as business receipt under section 6(2)(b) and therefore, eligible to claim allowance under section 13 of the Act. The tax treatment on such type of lessor is equal to the tax treatment on instalment sale which will be discussed further under the heading of instalment sale.

Further, section 49(3) is realistic in case of a lessor who is providing a lease loan covering the full market value of the asset. In such a situation, a lessor pays a market value of the asset to the asset selling person on behalf of the lessee. The asset selling company transfers the ownership of asset to the lessor. The lessor in turn provides a loan under finance lease to the lessee keeping such asset as a security. Hence, even section 49(3) apply in this situation on the lessor, no gain or loss is realized in the hands of lessor as market value of asset is equal to the cost of the asset.
But, the section 49(3) does not apply toa lessor who is providing a lease loan covering a part of the market value of the asset. In such a situation, the other part of the market value of the asset is paid by the lessee to the asset selling company directly. However, ownership of asset is transferred to the lessor by the asset selling company as an industry practice.

Under section 49(2), such ownership is treated as transferred to the lessee. However, in respect of such transfer, lessor shall not be treated as deriving an amount equal to the market value immediately before transfer as lessor has paid only part of the market value to the asset selling company on the requirement of the lessee. As such it is not realistic to compute gain or loss for the lessor at the time of the deemed transfer as per section 49.

The section 49 (4) is applied where a lessee under a finance returns the asset to the lessor before ownership passes to the lessee at the end of the lease agreement with the payment of last rental. In such an event, lessee is treated as transferring the ownership of asset back to the lessor. Then, above tax treatment under section 31 and 49 should be adjusted accordingly.

Example 11.6.1.1:

Company A wants to buy a car. The current market value of the car is Rs. 5.4 million. The company has only Rs.3 million and therefore, decided to finance the balance amount (Rs. 2.4 million) from a lease loan. Accordingly, the company paid the Rs.3 million to a Car selling Company and finance the Rs.2.4 million from a Finance Company. The terms and conditions of the lease loan mentioned in the lease agreement are as follows;

i. Lease term is 4 years
ii. Capital portion of the loan is Rs.2.4 million
iii. Interest rate is 20% per annum
iv. Monthly instalment

Capital Portion + Interest

v. By paying Rs.1000/- at the end of the lease term, the ownership of the asset is transferred to the company A (lessee).

Finance Lease Calculation

Formula for Declining Balance—equal installments payment (EMI)

EMI= P $\frac{r(1+r)^{\wedge}n}{(1+r)^{\wedge}n-1}$

Where,
P = loan amount (principal)
R = rate of interest per year/12*100
n = term of the loan in periods (ex: four-year loan, pay monthly installment then n=48)

EMI= 2,400,000 $\frac{20/12*100(1+0.01667)^{\wedge}48}{(1+0.01667)^{\wedge}48-1}$

EMI= 73,033

Capital portion of loan	Rs 2,400,000
Lease/financing term	4 years
Interest rate	20%
Monthly payment (Refer the above calculation)	Rs 73,033
Number of payments	48
Total interest	Rs 1,105,578
Total loan cost	Rs 3,505,578

Interest and capital repayments during first year (lessee)

Interest and capital receipt during first year (lessor)

	Starting balance	**Payment**	**Interest paid calculation**	**Interest paid**	**Principal paid**	**Ending balance**
Month 1	Rs 2,400,000	Rs 73,033	2,400,000x20/100x12	Rs 40,000	Rs 33,033	Rs 2,366,967
Month 2	Rs 2,366,967	Rs 73,033	2,366,967x20/100x12	Rs 39,449	Rs 33,583	Rs 2,333,384
Month 3	Rs 2,333,384	Rs 73,033	2,333,384x20/100x12	Rs 38,890	Rs 34,143	Rs 2,299,241
Month 4	Rs 2,299,241	Rs 73,033	2,299,241x20/100x12	Rs 38,321	Rs 34,712	Rs 2,264,528
Month 5	Rs 2,264,528	Rs 73,033	2,264,528x20/100x12	Rs 37,742	Rs 35,291	Rs 2,229,238
Month 6	Rs 2,229,238	Rs 73,033	2,229,238x20/100x12	Rs 37,154	Rs 35,879	Rs 2,193,359
Month 7	Rs 2,193,359	Rs 73,033	2,193,359x20/100x12	Rs 36,556	Rs 36,477	Rs 2,156,882
Month 8	Rs 2,156,882	Rs 73,033	2,156,882x20/100x12	Rs 35,948	Rs 37,085	Rs 2,119,797
Month 9	Rs 2,119,797	Rs 73,033	2,119,797x20/100x12	Rs 35,330	Rs 37,703	Rs 2,082,094
Month 10	Rs 2,082,094	Rs 73,033	2,082,094x20/100x12	Rs 34,702	Rs 38,331	Rs 2,043,763
Month 11	Rs 2,043,763	Rs 73,033	2,043,763x20/100x12	Rs 34,063	Rs 38,970	Rs 2,004,792
Month 12	Rs 2,004,792	Rs 73,033	2,004,792x20/100x12	Rs 33,413	Rs 39,620	Rs 1,965,172
					Rs 434,827	

The tax treatment can be summarized as follows:

- **Car Selling Company:** On the basis that the Car Selling Company sells the car to the finance lease company for its market value to enable the finance company to lease the car to Company A, then the Car Selling Company includes Rs. 5.4 million as business income (see section 6(2)(b)), with an offsetting deduction for the cost of the car as trading stock (as determined under section 13).
- **Finance company**: The lease by the Finance Company to Company A is treated as a sale and Company A is treated as the owner of the car. No gain or loss should arise on the sale for the Finance Company on the basis that the sale price (Rs. 5.4 million) should equal the acquisition cost (Rs. 5.4 million). However, the Finance Company is treated as holding a debt claim against Company A. The application of section 31 means that the payments under the lease will be recharacterized from rent into the payment of interest and the repayment of capital, with the interest treated as business income (see table below1) and the principal amounts treated as a non-assessable return of loan capital. The proportion of the payments that constitute interest will decrease from year 1 to year 5 due to the compounding interest calculation. When the loan is extinguished on the transfer of the car at the end of the finance lease, there will be no gain or loss on disposal of the debt claim because the principal repayments will equal the amount of the debt claim. Interest portion of payments will be subject to withholding tax at 14% (with no credit) to the extent the Finance Company is not a qualifying resident financial institution (see section 84).

Finance Company	**Interest income**	**Principal received**	**Total received**
Year 1	Rs 441,567	Rs 434,827	Rs 876,394
Year 2	Rs 346,170	Rs 530,224	Rs 876,394
Year 3	Rs 229,844	Rs 646,551	Rs 876,394
Year 4	Rs 87,996	Rs 788,398	Rs 876,394

- **Company A**: Company A is deemed to have acquired the car for its market value (Rs. 5.4 million). Even though this would ordinarily mean that Company A can depreciate the asset, no depreciation allowance is available in respect of a road vehicle (see paragraph 4 of the Fourth Schedule). However, Company A can claim a deduction of the interest portion of the payments that Company A makes to the Finance Company (see table below) under the finance lease (assuming the car is being used by Company A in the production of income as required by section 12). The principal amounts will not be deductible. When the loan is extinguished on the transfer of the car at the end of the finance lease, there will be no gain or loss on disposal of the liability because the principal repayments will equal

[1] Please note that the table assumes that the Commissioner-General has specified the use of monthly compounding of interest as per the example (see section 31(3)).

the amount of the liability. Company A will have a withholding tax obligation in respect of the interest portion of payments to the extent the Finance Company is not a qualifying resident financial institution (see section 84).

Company A	**Interest deduction**	**Principal paid**	**Total paid**
Year 1	Rs 441,567	Rs 434,827	Rs 876,394
Year 2	Rs 346,170	Rs 530,224	Rs 876,394
Year 3	Rs 229,844	Rs 646,551	Rs 876,394
Year 4	Rs 87,996	Rs 788,398	Rs 876,394

Installment Sale Agreements.

Installment sale is treated as an immediate sale under which market value is financed by the purchaser though a loan. That means the seller sells the asset in return of debt claim equal to the market value of the asset.

Hence, tax treatment in the hands of seller is that market value of the asset should be taxed in the year of sale (not at the end of instalment sale) under section 6(2)(g) and it will be allowed a deduction under section 13 of the Act. Further, seller will acquire a new asset as a result of this installment: that is a debt claim against the purchaser. In the hands of purchaser, market value of the asset can be depreciated under section 16 of the Act.

Independent to this tax treatment, section 31 applies on payments made under installment sale as described above.

Chapter 12 - Tax Payment Procedures

12.1 Tax payment method

Chapter VIII brings together the administrative provisions relating specifically to the payment of tax. Division I sets out general obligations regarding the payment of tax, including the method and timing of payment. The following divisions largely follow the process of paying tax. Division II begins with the point at which income tax must be withheld from payments during a tax year. Division III continues with the next point of payment, which is by instalment. Division IV deals with the traditional income tax payment procedure, i.e. on assessment.
Detailed guidance on the operation of the rules relating to withholding by employers can be found in this Manual under the section entitled "**5. Payment of Tax**"
.

12.1.1 Withholding by Employer

Section 83 instructs employers to withhold tax from income from employment at the rates specified in First Schedule to the Act. The First Schedule is a yearly schedule and so employers should base their withholding on the projected total income from the employment for the year. An employer must provide an employee with a withholding tax certificate within 21 days from the end of the year of assessment to which it relates, or where an employment ceases during the year of assessment, at the time that the employment ceases. The withholding tax certificate must be in the required form and contains pertinent information in relation to the withholding tax affairs of the employee in respect of that employment, including the amount of income received by the employee for that year of assessment and the amount of tax withheld.
A resident individual who only has income from employment that is subject to withholding by employer for a year of assessment will not be required to file a return for that year of assessment, s. 94(1)(a)(ii).

12.1.2 Withholding from Investment Returns.

Subject to Subsection (3), a person shall withhold tax at the rate provided under paragraph 10 of the First Schedule.

1. Following sources identified as investment income and are subject to withholding tax under section 84 of the Act and a person shall withhold the tax as per the paragraph 10 of First schedule of the Act;
   When make a payment of;
   i. Dividend
   ii. Interest
   iii. Discount
   iv. Charges
   v. Natural Resource Payment
   vi. Rent
   vii. Royalty
   viii. Premiums

ix. Retirement Payment
x. Payment from lottery
xi. Rewards from betting and gaming

2. The precedent partner or agent of partnership in Sri Lanka at the time of allocation of each partner's relevant share under subsection (9) of Section 53
3. The payment of allocation has a source in Sri Lanka

12.1.3 Withholding from service fees and contract payments (Section 85)

Following payment is subject to withholding tax by a person who pays;

1. Service fees to a resident Individual- for lecturing, teaching, examining, invigilating, or supervising an examination
2. As a commission or brokerage to a resident insurance, sales, or canvassing agent
3. As an endorsement fee;
4. In relating to supply of any article on a contract basis through tender of quotation;

12.1.4 Inland Revenue Act No. 24 of 2017

WHT at a Glance

Person	Income Type	Note	Rate (1st Sch 10 & Gazette)
Payment to any Resident Individual (S. 85, Gazette)	Teaching, lecturing, examining, invigilating, supervising an examination	Excess over Rs. 50,000/- Per Month {1st Sch. 10(c)} If ESC is applicable required a direction- Sec 85(3)(d)	**5%**
	Commission or brokerage to a resident insurance, sales or canvassing agent		
	Supply of any article on a contract basis through tender or quotation, Endorsement fee		
	Service provided in the capacity of independent service providers such as doctors, engineers, accountants, lawyers, software developers, researchers, academics, or any other similar service		
	Service of construction work, security service, janitorial service, consultation work of any kind, organizing of events, catering, designers, dress makers, tour guidance, entertainment, agency functions or any similar services or connected work where such services are provided under an agreement or otherwise		
	Any management service		
	Vocational services provided as an independent service provider		
Payment to any Non-Resident Person (S. 85 Gazette)	Service fee with a source in Sri Lanka	If ESC is applicable required a direction- Sec 85(3)(d) **(if no PE in SL - Final Tax)** {S. 88(1)(d)} ***On any amount***	Lower of **14%** or DTA rate
	Insurance premium with a source in Sri Lanka		
	Land, sea, air transport business		Lower of **2%** or DTA rate
	Telecommunication business		
Payment to any Person (Sec 84, Gazette)	Interest for senior citizen **(Final Tax)** (Excess of Rs. 1.5 Mn PA- Subject to Declaration) {Sec 88(1)(b)}	*On any amount-* **Exempt to charities which provides care to children/ elders/disabled in a home maintained -** 3rd Sch (i)	**5%**
	Interest for others (**Final Tax for Resident Individual, charitable Institution)** {S. 88(1)(b)}		
	Discount	*On any amount-*	**5%**
	Rent	*On any amount-*	**10%**
	Dividend (**Final Tax for Resident Person**)	*On any amount*	**14%**
	Charge,		
	Natural resource payment,		
	Royalty,		
	Premium		
	Retirement payment		
	Amounts as winning from a lottery, reward, betting or gambling **(Final Tax)**	Rewards over Rs. 500,000/- 3rd Sch (n)	**14%**
	Partner's relevant share of any partnership income	*On any amount-*	**8%**
	Sale price payable to the seller of any gems sold at an auction conducted by the National Gem and Jewellery Authority	*On any amount –* **Exempt if WHT deducted-** 3rd Sch (s)	**2.5%**

12.2 Tax Payable by instalment (Section 90)

A person who conduct a business or investment and receives income from employment but not subject to withholding tax under section 83 shall be paid quarterly instalments for the assessable income derives or expect to derive.

In the case of a person whose year of assessment is twelve-month period ending on thirty first of March, shall pay instalments of tax on or before the fifteenth day respectively of August, November, February and fifteenth day of the next succeeding year of assessment: or

In any other case on or before the fifteenth day after each three-month period commencing at the beginning of each year of assessment and a final instalment on or before the fifteenth day after the end of each year of assessment., unless it coincides with the end of one of the three-month period.

$$\frac{A - C}{B}$$

Where A - Is the current estimated tax payable under section 91 0or 92 by the instalment payer for assessment payment.

B – number of installment remaining as payable for the year of assessment.

C – tax already paid during the year of assessment.

PART II - TAX ADMINISTRATION

Contents

CHAPTER 1 - RECORDKEEPING AND INFORMATION COLLECTION

Chapter X of IRD Act serves two important functions. First, it provides extensive powers that enable IRD to collect information necessary to effectively audit taxpayers and enforce tax laws. Particularly, it requires financial institutions to keep account of transactions with clients, including their identity. Second, it provides the requirement for keeping books and records, and ensures that taxpayers maintain information for the period of time that the IRD is able to reassess. It also provides for taxpayer protections.

1.1 Accounts and Records

This addresses the important requirement that taxpayers maintain appropriate books and records. Every taxpayer engaged in business or investment activity or who is required to make a return under tax legislation to keep and maintain in records and accounts sufficient to record all transactions and to ascertain the gains and profits made or the loss incurred in respect of those transactions. Taxpayers must also keep source documents and underlying documentation utilized in the creation of the records and accounts. These documents must be kept for five years from the date on which the transaction took place, unless a longer retention period is needed to match the period of limitations on assessment for any tax period to which the records are relevant. The person may be required, at their expense, to provide a translation of a record acceptable to the Commissioner-General. The Commissioner-General may specify circumstances under which the taxpayer may use an approved accountant and a simplified system for recordkeeping for small businesses (Section 120).

1.2 Obligations of Financial Institution

A bank or financial institution is required to keep account of all transactions with a client, including the client's identity (Section 121).

1.3 Access to Information, Assets, and Land

It sets out the conditions under which an authorised officer may enter a business premises or other premises open to the public without prior notice for an authorized purpose, may enter a taxpayer's dwelling or other private and non-business premises for an authorized purpose, and may enter on property to survey and value it.

If an authorised officer seizes a record or other item, the Commissioner-General may make a copy of the record or other item and must return the original to the person in the shortest time practicable, unless otherwise permitted by any court order. A copy of a document made pursuant to the power conferred by this section may be produced in a Court and has the same evidentiary value as if it were an original. Diplomatic, consular, or other missions of foreign countries and international organizations are excluded from the access provisions of this Act.

The provision also includes taxpayer rights. For example, a person whose books, records, or other items have been seized may examine them and make copies, at the person's expense, during office hours. The Commissioner-General or an authorized officer must sign for all records, books, or other items removed and retained and must return them to the owner within fourteen days of the conclusion of the investigation or related proceedings.

A person may assert privilege, for example, solicitor-client privilege, over documents or other evidence which the Commissioner-General wishes to seize or examine. In that case, the materials over which privilege is claimed must be kept into envelopes which are then sealed and retained unopened by an officer of the IRD pending an application by the Commissioner-General to a court of competent jurisdiction to determine whether the items in question are privileged. Once the Commissioner-General requests documents and a taxpayer or other person does not comply, judicial proceedings are not allowed unless the Commissioner-General agrees. The owner or lawful occupier of the premises or place subject to access must provide all reasonable facilities and assistance to the Commissioner-General or authorised officer.

The Commissioner-General may require a peace officer to be present for the purposes of exercising powers under this section **(Section 122).**

1.4 Notice to Obtain Information

This section applies where the Commissioner-General seeks information or requires to appear in person. Significantly, for the effective operation of the tax administration, sections 29 and 30 have an effect notwithstanding a law relating to confidentiality, privilege or the public interest with respect to the production of or access to documents or other evidence, including a law relating to bank secrecy and any contractual duty of confidentiality (**Section 123)**.

1.5 Search and Seizure Warrants

These sections provide the legal framework for the IRD to obtain and execute a search and seizure warrant. The Commissioner-General may apply to a judge or magistrate ex parte for a warrant. The provisions detail the material to be provided to the court and the information to be contained in the warrant. The warrant must be produced to the owner or lawful occupier of the premises. Where the warrant is produced, the authorized officer may have access to the property, including open anything that the authorized officer reasonably suspects contains relevant material, make an extract or copy or seize relevant material, or search any person in the premises. There are some protections for taxpayers within the provisions, including that the authorized officer must make an inventory of the

material and sign for material retained; similarly, the person may refuse admission where a warrant is not produced; also the person must be searched by someone of the same gender; that the person may attend to make copies of any materials seized and so on. The Commissioner-General may require a police officer to be present.

The authorized person may still execute a search and seizure without a warrant if the owner or lawful occupier consents in writing or if there is concern that material will be imminently disposed of (**Sections 124, 125)**

1.6 Tax Returns

Chapter XI of the Act is a short, but important section that crystallizes taxpayers' obligation to file tax and information returns and enables applications for extensions of time to file.

This section imposes on taxpayers the requirement to furnish the Commissioner-General with a tax return if required by law, within the time and at the place specified by that law, or as demanded by the Commissioner-General. The Commissioner-General may specify-

(a) the form for returns;
(b) the information to be furnished on the return and attachments, if any, required to be filed with the return; and
(c) the manner of filing.

Taxpayers must attest to the accuracy and completeness of tax returns. If a return or part of a return was prepared by some other person for reward, that other person must also sign the return. The Commissioner-General may, by notice in writing, require a person to file fuller or additional returns (**Section 126).**

1.6.1 Notice to require filing

This section allows the Commissioner-General to require taxpayers who have failed to furnish a return to do so. A taxpayer who complies with such a notice may still, however, be liable for interest and a late filing penalty due to the failure to file (**Section 127).**

1.6.2 Return deemed to be furnished by due authority

This section provides a presumption that a return purported to have been furnished by a taxpayer was in fact furnished by that person and provides that a taxpayer's signature attests that the taxpayer is aware of all matters contained in the return. A taxpayer therefore cannot claim not to have read the return and therefore not to be liable for misstatements on that return (**Section 128).**

1.6.3 Information returns

This section confirms that provisions applying to returns also apply to a return of information. This includes, for example, rules about signing the return and late filing penalties (Section 129).

1.6.4 Extension of time to file returns

This section allows the Commissioner-General to permit a taxpayer to file late but clarifies that this does not alter the due date for payment unless an extension of time to pay is expressly granted. The Commissioner-General may grant the extension of time to file only if the taxpayer applies for the extension before the due date. A taxpayer who files within the extension deadline but pays the tax late will be liable for late payment penalty and interest, if no extension of time for payment was granted (Section130).

1.6.5 Tax return duly filed

It confirms that unless the contrary is proved, a return filed by or on behalf of the taxpayer is treated as filed by the taxpayer or with the taxpayer's authority (**Section130).**

CHAPTER 2 - ASSESSMENTS

Chapter XII of the Act sets out the rules that govern assessments. There can be more than one assessment event for a particular tax period, e.g., the initial assessment (self-assessment) by the taxpayer and a subsequent revised assessment by the Commissioner-

General. Assessments and revised assessments must be made within four years except in the case where there is a fraud or a failure to furnish a tax return. This Chapter provides the IRD with the authority to undertake default, advance, and amended assessments. The Commissioner-General need not to provide detailed reasons in support of the assessment, but the taxpayer may object to the assessment in accordance with the proceedings set out in Chapter XIII (below).

2.1 Self-assessments

This section provides the baseline rules for taxpayer assessments. Assessments are to be made in the manner prescribed by this Act and by the relevant law to which the Act applies. As a general matter, assessments may be based upon the information supplied by the taxpayer in a tax return and upon any other relevant information available to the Commissioner-General. Where a taxpayer calculates the amount of tax in a tax return as required by the relevant law, the taxpayer's self-assessment is an assessment. (One implication of this is that the amount of tax self-assessed is due, without requiring an assessment or review by the Commissioner-General (Section 132).

2.2 Default Assessments

This section enables the Commissioner-General to make an assessment of the tax payable, based upon best judgement and information available if a taxpayer fails to file a tax return as required. The Commissioner-General must serve the taxpayer with notice of the default assessment (Section133).

2.3 Advance Assessments

This section facilitates an assessment of a taxpayer in advance of the usual due date, by notice in writing, if the Commissioner-General has reasonable grounds to believe that a taxpayer may leave Sri Lanka before the regular due date (**Section 134).**

2.4 Amended or additional assessment

This section enables the Commissioner-General to make a new assessment or revise an assessment previously made, if the Commissioner-General is of the opinion that the original assessment was incorrect and the new or revised assessment is made within the required time limits. The original assessment may be amended mainly for two reasons by the Assistant Commissioner**.**

- To correct the error of a carry forward loss declared for a year of assessment.
- To correct the incorrect declaration of profit or income declared for a year of assessment**.**

2.4.1 Time limit to amend assessment

If amendment is to be made for a self-assessment

I. If the assessment is based on fraud or wilful evasion no time limit to issue the assessment.
II. Otherwise 30 months from the date of the self-assessment return filed.

In case of other assessments 30 months is calculated from the date the original notice of assessment served on the taxpayer.

2.4.2 Further Amendments

Further amendment is possible within latter of

(a) four years after
i. the date of return furnished for self-assessment by the tax payer.
ii. In any other case from the date of the original assessment served.

No amended assessment can be issued within 1 year from the earlier assessment. **(Section 135).**

2.5 Application for Making an Amendment to a Self-assessment

When the self-assessment return has been filed by the tax payer and after that if there is any amendment is due according to the view of the tax payer may make an application to CGIR, within 30 days of the self-assessment return. CGIR may decide either to accept the application or not. Such decision shall be conveyed to the tax payer within 90 days of application being filed. ***(Section 136).***

CHAPTER 3 - OBJECTIONS AND APPEALS (Sec 137 - 144)

Chapter VI provides taxpayers with the process for challenging a tax assessment or other decision of the officers of the IRD and provides procedural safeguards and required timelines for both taxpayers and the Commissioner-General. Notably, the Chapter streamlines and makes more efficient the review and appeal processes. However; taxpayers are required to pay or provide security for their disputed tax debts and that interest will be charged on unpaid amounts. This type of procedure is guaranteed to recover taxes within shorter periods and also no any incentives be allowed for taxpayers for delaying in resolving disputes or to bring frivolous disputes forward.

3.1 Administrative Review

Under the new IRA; appeals make to the CGIR is called as request for administrative review. But it has not been changed the substance of process of appeals. *Section 139* provides requirements for the first stage for a taxpayer seeking to challenge an assessment or other decision of the IRD –
The hearing of such request is called as administrative review.
A request for administrative review must be made to the:

Commissioner-General in writing
Not later than thirty days after the taxpayer was notified of the decision,
And must specify in detail the grounds upon which it is made**.**

The Commissioner-General shall consider the taxpayer's request and notify the taxpayer in writing of the Commissioner-General's decision and the reasons for the decision

3.2 Objection - Section139 (3)

Where the objection is against an assessment which has been made in the absence of a return required to be made, the notice of objection must be sent together with a return duly made.

3.2.1 Late Requests to CGIR

Where a taxpayer has not made a valid request within thirty days as specified, CGIR can accept late requests for review in case of

- Absence of country
- Sickness or
- Any other acceptable reason

if a person is dissatisfied with the results of an administrative review, the person may appeal to the Tax Appeal Commission.

3.2.2 Acknowledgement of Request

Once the request for an administrative review is received by CGIR; it must be acknowledged within 30 days. The said date of acknowledgement is deemed to be the date of receipt of such request. (Sec: 139(4). CGIR may delegate his power to a higher officer

to consider the said request and after hearing of such request; officer should inform **his** decision to the tax payer along with the reasons for the decision. However, the official to whom the power is delegated should be an official other than the one who issued the assessment.

CGIR may give his decision by

- Confirming the existing assessment/decision, or
- To amend it imposing an additional amount or
- Reducing the amount (including nil amount)

CGIR may hear the evidence & maintain the records for such hearing and also ensure that:

CGIR shall determine the administrative review within 90 days.

General provisions relating to appeals

Section 141 (Burden of Proof) lays the burden of proof on the taxpayer or person making an objection to an assessment.

Section 142 (Appeals do not Suspend Collection of Amounts) makes clear that despite an objection or appeal, the tax liability remains due and payable, unless the Commissioner-General grants an extension of time. The Commissioner may decide to accept payments in installments or appropriate security for the disputed tax liability.

3.2.3 Finality of Assessment

Section 143 stipulates that if the deadlines imposed for a review of an assessment is not used or decision is missed, an assessment is treated as final. The Commissioner-General may nevertheless issue a new or a revised assessment within the timelines permitted and a taxpayer may file an amended return but only if the tax shown on the amended return exceeds the tax assessed.

Provides that if a person is dissatisfied with the results of an administrative review, the person may appeal to the Tax Appeal Commission within 30 days. This appeal may only occur after –

- a decision has been received from the Commissioner-General; or
- Ninety days have lapsed since the request for administrative review was made.

3.3 Late Appeal to TAC

The taxpayer may be allowed appeal against the assessment to Tax Appeal Commission after the deadline for appeals has passed if the Tax Appeal Commission is satisfied that owing to absence from Sri Lanka, sickness or other reasonable cause the taxpayer was prevented from giving notice of appeal within 30 days, and that there has been no unreasonable delay on the appellant's part.

3.4 Appeal to the Court of Appeal

Section 144 allows either party to a proceeding before the Tax Appeal Commission who is dissatisfied with the decision of the Tax Appeal Commission to file a notice of appeal with the Court of Appeal within one month after being notified of the decision. The appealing party must serve a copy of the notice of appeal on the other party to the proceeding before the Tax Appeal Commission.

- An appeal to the Court of Appeal, which may be made only on a point of law, may not be made unless an appeal request to the Appeal Commissioners has first been made, and –
- a decision has been received from the Tax Appeal Commission; or
- Ninety days have elapsed since the request for appeal to the Tax Appeal Commission was made and no response to the request for appeal has been received from the Tax Appeal Commission.
- If an appeal is made from a decision of the Tax Appeal Commission, the Tax Appeal Commission must provide a written statement of their decision, including a summary of the evidence, their finding of the facts, and their conclusions on the points of law involved.

CHAPTER 4 - Liability for payment of tax and connected matters

4.1 Recovery of Tax

General (Section-160)
The Commissioner General may proceed with remedy once the tax payer is in default.
Period of limitation for collection (Section-161)
CGIR may institution of action commence within five years of the date on which the tax payer was in default

Eg: Department can make an assessment within four years of the end of the year of assessment. Assume an assessment is issued just at the end of the period and the notice of assessment also served. If the tax payer does not make an appeal but not pay the tax. CGIR has additional six years to collect the tax

4.1.1 Collection through court proceedings (Section-163)

Tax is due and payable shall be a debt to the Government
Where a person fails to pay tax when it is due, the CGIR may commence proceeding in a court of competent jurisdiction to recover the debt outstanding in respect of the amount due.

A certificate with the signature of CGIR stating the name of defaulter the amount of tax shall be a sufficient document to the court to give a judgement
.

4.1.2 Seizure of property-Through a lien (Section-164)

- Where a tax payer fails to pay a tax by the due date a lien in favour of CGIR is created in that amount (Interest + penalty + cost of collection) on all property belong to tax payer.
- A lien shall arise at midnight at the commencement of the date of default.

4.1.3 Execution against tax payer's property (Section165)

- When the Tax payer is in default the CGIR may cause execution to be levied on the tax payers' property when the tax payer has failed to pay tax within thirty days after service of the notice.

4.1.4 Sale of seized property. (Section-166)

- The CGIR shall sell the seized property pursuant to a levy. The sales proceeds first be charged against the expenses of recovery then against the liability for penalties, interest and then tax. Excess be returned to the taxpayer.
- The date time and place of sale shall be published in a gazette.

4.1.5 Departure Prohibition Order (Section-167)

CGIR may issue a prohibition order to stop (through immigration authorities) a tax payer from leaving Sri Lanka if the tax payer is in default and fails to pay or make satisfactory arrangement for the payment of the tax in default.
This prohibition order shall remain in force until withdraw by the CGIR.

4.1.6 Priority in bankruptcy. (Section-168)

Provide for priority in bankruptcy for tax debts, in the case of individual the trustee and the liquidator of a company which is being wound up.

4.1.7 Offset Against payment (Section-169)

Where a government Department, institution, or Ministry is about to make a payment to any person (other than salary and wages) that Department may apply the whole or part of that payment in respect of taxes default under 152 with consent of that person.

4.1.8 Collection from Third Parties (Section-170)

If the tax payer is in default, the CGIR may serve a notice in writing on a third-party debtor. After receiving the notice, the third part debtor shall remit such moneys to the CGIR and on receiving such notice, the third-party debtor shall not pay any amount to the tax payer until the CGIR with draw the notice.
A notice be served on the tax payers employer required to withhold and pay to the CGIR some part of future wages or salary that becomes payable to the tax payer. However, first Rs 75000.00 of the wages per month shall not be subject to withhold.

4.1.9 Compliance with Notice (Section-171)

A third party who acts upon 170 shall be treated as having acted with the authority of the taxpayer.
This section shall apply irrespective of any other written law, contract, or agreement.
If the third party is unable to comply with the notice due to lack of money in the name of tax payer the Third party notify the CGIR in writing with the reasons for such inability.

4.1.10 Preservation of Assets (Section -172)

If the Commissioner General feels that the tax payer will not pay the full amount of tax owing and when due or the tax payer will take steps to frustrate the recovery of the tax, the CGIR may make an application to the District Court requesting for an "Asset preservation order" to preserve the Assets.
This preservation order valid for 90days and may be extended by the court on application by the CGIR.
A person who fails to comply with such preservation order shall become personally liable.

4.1.11 Non –arm's length transferees (Section-173)

If a tax payers liability has not been satisfied after levy of execution on property known to the CGIR, a person who has received assets of the tax payer in a transaction that is not at arm's length in the period of one year preceding the date of the levy, is secondary liable for the tax to the extent of the value of the assets received.

4.1.12 Transferred tax liabilities (Section-174)

When a taxpayer has a liability in relation to a business carried on by the taxpayer and the tax payer has transferred all or some of the assets of the business to an associate transferee shall be personally liable for the transferred liability of the tax payer in relation to the business.

4.1.13 Receivers (Section-175)

Receivers are required to notify the CGIR of the receiver's appointment within 14 days after being appointed**.**
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 CGIR.
Receiver means a person who, with respect to an asset situated in Sri Lanka is a liquidator of a company or other entity, appointed out of court or by a court, a trustee in bankruptcy, a mortgage in a procession, an executor, administrator, or heir of a deceased individual's estate. Conducting affairs of an incapacitated individual, a successor in a corporate reorganization

4.1.14 Collection from parties other than tax payers – Eg ; Managers of entity(Section -149)

Instances where an entity fails to pay tax on time, manager of the entity shall be jointly and severally liable with the entity. Amounts payable to CGIR under this section shall be personal tax liability of the Manager. However, if the manager who has exercised the degree of care, diligence, and skill reasonably prudent of his capacity such liability will not be fall upon him.
"Manager" means a person act as the manager, in case of a company a director, the chief executive officer, chief financial officer, of the company.

4.2 Default in payment (Section-152)

The CGIR may send a notice to the tax payer demanding payment when a tax is not paid by the due date on which it became due and payable. If payment is not made within twenty-one days after service of the notice, the CGIR has the right to institute action to collect amounts specified in the notice.
The tax payer shall be in default, twenty-one days after service of the notice in respect of any amounts remaining unpaid.

However, where the tax payer has entered in to payment arrangement with CGIR or extension has been (Sec-151) granted by CGIR twenty-one-day rule shall not apply.

4.2.8 Liability of tax payer and due date- Section (145(5)

Where a tax payer fails to pay tax on the due date, the tax payer shall be liable for any costs incurred by the CGIR in taking action to recover the unpaid tax (Section-145(5))
.

4.2.9 Extinguishment of uncollectible amounts (Section-162)

If the CGIR is unable to recover an amount of tax, interest, or penalty due and payable by a person, the Minister may with the consent of CGIR and approved by the cabinet order the extinguishment of the liability as a debt due to the Government.

4.3 Penalties and Criminal Proceedings

As stated in the new IRD Act there are two types of penal actions.
They are,

1. Penalties under chapter XVII by CGIR
   And
2. Criminal proceedings under chapter XVIII by competent court

Although, there is no imprisonment on the 1st category of offences and the latter offence are subjected to both fine and imprisonment. It is appropriate to treat two types of activities as civil action and criminal action.

4.4 Offences under Chapter XVII

Criminal offences and civil offences are generally different in terms of their punishment. Criminal cases will have jail sentence as a potential punishment, whereas civil cases generally only result in monetary damages or orders to do or not do something.

In the case of Criminal cases it may involve both jail sentences and monetary punishment in the form of fines.

Hence the offences under the chapter xvii has the characteristics of civil offences. The offences under there are,

1. Failure to register or notify the changes in tax payer. (Sec. 177)
2. Late filling of tax returns (Sec. 178)
3. Late Payments (Sec. 179)
4. Negligent or Fraudulent under payment (Sec. 180)
5. False or misleading statements (Sec. 181)
6. Failure to maintain documents or provide facilities (Sec. 182)
7. Failure to comply with 3rd party notice (Sec. 183)

8. Transfer pricing penalties (Sec. 184)
9. Failure to comply with notice to give information (Sec. 185)

4.4.8 Burden of Proof

As per sec. 176(4), burden of proof on all the above cases are on the Commissioner General of Inland Revenue. The proof of the cases is to be done on the balance of probability.
(A). Penalty on failure to register or notify the changes in tax payer.
(177) When a person has a taxable income, he is required to register with the CGIR not later than 30 days after the end of the basis period for that year.
In addition to this he should notify any changes of Name, Address place of business, etc. If he fails to register he is shall be liable to pay a penalty of Rs. 50,000.00

Example 4.4.1.1:

Mr. A has a taxable income of Rs. 750,000.00 for the Y/A 2018/19. However, he has not registered for income tax. If A has not registered on or before 30th April 2019, he is subjected to pay a penalty of Rs. 50,000.00 for failure to in terms of Sec. 177.

4.4.9 Late filling of tax returns (Sec. 178)

a) 5% of the amount of tax payable plus 1% of the amount of tax due for each month or part of the month.

b) Fifty thousand plus, further 10,000 for each month or part whichever high

Example 4.4.2.1

Mr. B carries a business of wholesale and retail trade and he is a registered tax payer for the year of assessment 2018/2019 he has failed to furnish the tax return on the 30th November as required by Law.
However, tax payer has furnished the tax return on the 31st March 2020.The tax due on the return amounts to 2,000,000. The penalty on the late return will be calculated as follows.

Tax due on 30th November 2017 but not paid as per return	– 2,000,000
Penalty (5%)	- 100,000
	- 2,100,000
Penalty for December (2,000,000 x 1%)	- 20,000
January (2,000,000 x 1%)	- 20,000
February (2,000,000 x 1%)	- 20,000
March (2,000,000 x 1%)	- 20,000
Total Penalty & Tax	- 2,180,000

In addition to this interest will also be accrued to the total amount of tax at 1 ½ % for each month.

4.4.10 Late Payments (Sec. 179)

i. A person who fails to pay all or part of a tax due for a tax period within 14 days of the due date shall be liable to pay 20% of the amount of tax.

ii. If he fails to pay all or part of tax on due date **specified in a notice of assessment** the penalty of 20% will be payable.

iii. When a person fails to pay all or part of **the instalment** after the 14 days of due date shall be liable to pay 10% of the amount of the tax due.

However, no penalty is due if CGIR has given extension period for the instalment payments.

4.4.11 Negligent or Fraudulent underpayment (Sec. 180)

Where tax is underpaid or incorrect statement or material omission as a result of intentional conduct or negligent. If under payment is,

i. Higher than 10 million Or

ii. Higher than 25% of the person's tax liability

Penalty to be charged - 75% of the underpayment.

If the above conditions are not satisfied it will be 25% of the under payment.

Example 4.4.4.1:

Mr. X has to furnish the tax return. As per return tax payable amount is 200,000.00. However, it is found after the audit the amount under paid is 300,000.00. The penalty is calculated as follows.

Persons tax liability	- 200,000
25% of the person's liability	- 50,000
Amount of under payment	- 150,000

Therefore, amount of under payment is higher than 25% of the person's liability.

Hence penalty will be 75% of the under payment. That is 300,000 x 75% = 225,000

4.4.5 False or Misleading statements (Sec. 181)

If any person makes a statement to a tax official that is Misleading or false statement which would result less than correct amount or If it is a refund it would have been higher than actual amount if the statement accepted by the tax official, the person is liable to pay penalty greater of,

a) 50,000 Or

b) The amount by which tax payable or refund would have reduced or increased if it were determined on the basis of such false statement.

The statement includes,

1. Any document, notice, certificate, any report etc.
2. Any information which is also be furnished under this Act
3. Any reply made by a person to any question asked by any tax official.

Example 4.4.5.1

Mr. D is the owner of a Manufacturing business. He has provided false statement of debtor balance in respect of whole sale dealer. It is found that debtors balance declared as Rs. 100,000 is less than actual value for the Y/A 2018/19 due to this it is found that the total tax payable amount reduced to 28,000.00. Hence penalty on the above misleading statement, amounted to Rs. 50,000.00

4.4.6 Failure to maintain documents or provide facilities (Sec. 182)

Under Sec. 120(3), it is necessary to keep proper book and records by any person who is carrying on a business. Failure to maintain proper records render the person liable to a penalty of 1,000.00 per day till failure continues.
However, CGIR shall issue warning notice and if he complied with the notice NO penalties will be levied.
Failure to provide facilities & assistance to tax official – maximum penalty of 10,000.00 shall be imposed.

4.4.7 Failure to comply with third party notice (Sec. 183)

when a tax payer is in default, the CGIR may serve a notice to a third-party debtor. On receiving such notice, the 3rd party debtor, shall pay the CGIR the amount the tax payer is in default.
3rd party debtor means a person who owes money to defaulter.
If a person fails to comply with this notice, he shall be liable for a penalty of 25% of the tax payable by the defaulter.

Example 4.4.7.1

Mr. X as a third-party debtor asked to pay Rs. 300,000.00 on behalf of a default tax payer by the CGIR. Mr. X failed to comply with this notice. Mr. X is subject to penalty of Rs. 75,000.00 (25% of Rs. 300,000.00)

4.4.8 Transfer pricing penalties (Sec. 184)

1. Required documents not maintained – 1% of aggregate value of transaction.
2. Required document not furnished – Penalty of Rs. 250,000.00
3. Non-disclosure of required information – 2% of aggregate value
4. Documents have not been submitted on specified date – Rs. 100,000.00
5. Concealed the particulars of his income – 200% of the value of additional tax
6. Furnishing inaccurate particulars of income – 200% of the value of additional tax

4.4.9 Failure to comply with notice to give information (Sec. 185)

Penalty of not exceeding 1 million
However, if a person liable for penalty shows reasonable cause for the failure to comply with the provision of the Law.
CGIR may,

1. Refrain whole or in part from assessing the penalty
2. Remit or waive in whole or part & penalty that has been levied.

Further except under negligent and fraudulent under payments in all other cases the period of limitation for assessing a penalty shall be five years after the violation which causes the penalty.

Person's liability to pay penalty arise on the making of an assessment by the CGIR.

4.5 Criminal Proceedings

4.5.1 Evasion

Sec189 – A person may guilty of an offence. If he,

1. Willfully evade or attempts to evade tax.
2. Willfully and fraudulently claim a refund of tax which the person is not entitled.

If the person is convicted under the offences stated above, he is liable to pay a fine Not exceeding 10 million rupees or to imprisonment for term Not exceeding two years or both such fine and imprisonment.

In proceeding against any person for evasion the burden of proof that the person has evaded the tax lies on the tax department. The burden lies with the state to prove that a person has evaded tax by these means and must proof beyond reasonable doubt to make a person liable under this provision.

Sec 207 – Act No 10 of 2016 stated that the admissibility of evidence in such case. However, there is No such provision in this Act.

In the case of Jayanetti Vs Mitrasena the department prosecuted for making a false return of Income. One of the issues for decision in the appeal was statements of a confessional nature admissible in evidence. The confession was held admissible AC is not prevented by secrecy provisions from disclosing statements and facts in his possession to the state council.

In the case of Chellappa Vs CIR it was held that to attract punishment, the omission must be done deliberately with evil intention of defeating unlawfully the object of the state by knowingly presenting false picture.

1. If evidence confirm an undisclosed income it is possible to issue assessment. Then it is a rebuttable presumption that tax payer has not declared the correct income.
2. In such a case burden of proof will be on the tax payer to rebut the assessment is correct. However, in case of willful evasion or fraud, the burden of proof rest with the department.

4.5.2 Impeding administration

A person who willfully impedes or attempt to impede the Department shall be liable on conviction for a fine of not exceeding 1 million.
Impedes administration means,

1. Fails to comply with a request to produce documents or appear before official of the department.
2. Fails to file a return
3. Producing false identity member or making false statement.
4. Refuse to produce any document requested by tax official.
5. Fails to maintain records or fails to comply with notice.
6. Impedes the determination assessment or collection.

4.5.3 Failure to preserve secrecy (Sec. 191)

If any person fails to preserve secrecy and violates confidentiality provision under section 100, he is guilty of an offence and shall be liable on conviction for a fine not exceeding 1 million rupees or imprisonment for a term not exceeding one year or both fine and imprisonment.

4.5.4 Offences by tax officials

Any tax official who performs any duty under this Act ask for any pecuniary or other benefit in cash or in kind from any person except an officer lawfully entitled, commits as offence and liable on conviction for a fine not exceeding 1 million or imprisonment not exceeding 1 year or to both fine and imprisonment. Further in addition to this court may impose the tax that has not paid as a result of officer's wrongdoing which is not recoverable from the tax payer.

The CGIR may compound an offence with a fine (except under Sec. iii and iv) if the person concerned request the same in writing. However, request must be made to CGIR before commencement of the court proceedings.

4.6 Interest

4.6.1Liability for Interest (157)

If a tax payer has not paid the tax by the due date, he is liable for interest from the due date. Unlike penalty, interest is payable even though extension of time for payment of tax given by the CGIR.
Interest to be calculated separately.
In case of revised assessments, the due date for calculation of interest shall be the original due date of the tax.

4.6.2 Refund late interest (158)

If the CGIR has to pay back the interest recovered from the tax payer, which is not due from taxpayers, and has to be refunded to the tax payer from the due date of the tax payable or date of payment of the tax whichever is later.

Example 4.6.2.1: Department issued an assessment on Mr. A for the Y/A 2018/19.
As per assessment the due date of tax payment is on or before 31st March 2020.
Tax payer made the payment with interest accrued to it. However, it has been transpired at the appeal that the return is acceptable as it is.
the tax payer has paid the interest and taxes on 10th of March 2017
however, in case of tax refund, no interest shall be payable if this refund of tax has been made within 60 days of claim for such refund

159 – (1) Rate of interest on any interest payable by the taxpayer- 1 ½ % per month or part of the month.

(2) Rate of interest on any interest payable by the CGIR to a tax payer- ½ % per Month or part of the month.

Example 4.6.2.2- Interest payable

A person's tax amounting to 100,000/- fell due on 1st June 2019. The tax and interest payable are calculated as follows.

Tax due on 1st June 2019	-	100,000
Interest for June - 1 ½ %	-	1,500
		101,500
Interest for July – 1 ½ %	-	1,522
		103,022
Interest for August - -		1,545
		104,567
Interest for September	-	1,568
Tax or Interest payable on 30.09.19	-	106,135

The tax is Rs. 100,000/- and interest is 6135/-

CHAPTER 5 - RULINGS

"Rulings" as a concept is not new to the Inland Revenue law. The same concept has been incorporated into the Inland Revenue Act No.10 of 2006 under Sec: 208A. The purpose of incorporating such a concept into tax law is to maintain consistency & uniformity in tax administration while providing a guidance to general public & to tax administrative officers. This concept has been brought into the new Inland Revenue Act in a more elaborative manner under the headings of "public & private rulings".

5.1 Public Rulings (sec 104:)

Public rulings set out the CGIR's interpretation with regard to the application of Inland Revenue Act. CGIR may issue public rulings in order to overcome the ambiguities that may be caused in interpreting the provisions of the Act. This may offer to all kinds of users of the Act an opportunity to rely upon the public rulings as a guidance in interpreting the grey areas of the Act.

A public ruling will be issued by the CGIR by publishing the notice of ruling in the Gazette & in Department web site. In publishing the ruling, it should be given a particular identification number & should state it to be a public ruling for all purposes of tax. Further a heading referring to the subject matter of the ruling has to be stated & then shall set out the interpretation made by CGIR under that heading.

Once a notice of ruling is published in the gazette & in the web site of the department the particular ruling comes into force from the date specified in the ruling as to be the effective date. If no such date is specified in the ruling the effective date shall be the date of publication. From that effective date onwards CGIR is bound by the ruling to follow the same until it is withdrawn by him. CGIR may withdraw any ruling issued by him at any time having published the notice of withdrawal in the gazette & in department's website.

If it is subsequently found that any public ruling issued by CGIR is inconsistent with any existing law, it is mandatory to withdraw such ruling as to the extent it is necessary to overcome that inconsistency. The effective date of withdrawal will be specified in the notice of the withdrawal that should be published in the gazette & Department' web site.

5.2 Private Rulings

As opposed to public Rulings, private rulings will be issued in respect of a particular transaction of a tax payer setting out CGIR's position on its tax application. Accordingly, a particular tax payer who wishes to have a private ruling be issued in respect of him, shall make a written application to the CGIR making his request. The application shall state the full details of the questioned transaction, while submitting all the documents relevant to it, specify the question precisely & also provide a full statement by the applicant setting out his opinion regarding the tax application on the questioned transaction.

When receiving an application for a private ruling, it shall be referred to a committee namely "interpretation committee" consisting of senior officers of the department appointed by CGIR. The committee may decide whether to accept or to reject the application. On Acceptance of an application, the committee would commence their review over the facts & documents available, if needed may bases on certain assumptions & would issue the ruling to the relevant applicant. CGIR may specify a reasonable fee on the applicant in this regard.

A notice of a private ruling shall state that it is a private ruling & shall have an identification as to the applicable tax payer, tax period, & transaction & states the assumptions based on issuing the ruling. CGIR may publish the ruling in Department's web site but without disclosing the identity of the applicant. A ruling so issued is binding upon the CGIR with regard to the particular tax payer in whose respect it was issued subject to that full & complete details of the transactions have been provided to CGIR. However, the ruling does not bind the CGIR in respect of any other tax payer even though on similar transactions in that tax payer's respect.

CGIR may withdraw fully /partly any ruling issued by him at any time having served the notice of withdrawal on the relevant tax payer. The withdrawal becomes effective from the date specified in the notice. Whenever it is found that a ruling so issued is inconsistent with an existing law, it is mandatory to withdraw the ruling to the extent that inconsistency can be overcome.
There may be instances where the CGIR may reject the applications made by Tax payers requesting private rulings. Such instances are specified in the section 108 of the Act in such an instance CGIR shall provide his reasons to reject the application.

Rulings whether it is public or private in nature, represent just the opinion of the CGIR regarding the application of the provisions of the Act. Therefore, no ruling can be challenged by any tax payer by a formal way of review or objections. If a tax payer considers any ruling issued by CGIR is inconsistent with the existing law he may choose not to follow it, however if an assessment was raised on a tax payer based on such a ruling it can be challenged in any of the manner stipulated in the ACT.

CHAPTER 6 - SCHEDULES

First Schedule	-	Tax Rates
Second Schedule	-	Investment Incentives
Third Schedule	-	Exempt Income
Fourth Schedule	-	Capital Allowances, Balancing Allowances and Assessable Charges
Fifth Schedule	-	Qualifying Payments and Reliefs
Sixth Schedule	-	Temporary Concessions

6.1 First Schedule – Tax Rates

6.1.1 Tax rates for resident and non - resident individuals.

Tax Rates for the taxable income of a resident or non-resident individual for a year of assessment.

Taxable Income (Rs)	Tax Payable
Upto 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%
3,000,000 – 3,600,000	24%

6.1.2 Tax on Employment Income

The following types of income are taxed under the table mentioned bellow.

(a) amount received in commutation of a pension;

(b) amount received as a retiring gratuity;

(c) amount received as compensation which the Commissioner General considers to be uniformly applicable to all individuals employed by the employer;

(d) amount paid to a person at or after the time of retirement from employment from a provident fund approved by the Commissioner-General that does not represent the person's contributions to that provident fund;

(e) amount paid to a person from a regulated provident fund that does not represent the contributions made by the employer to that provident fund before April 1, 1968, and the interest which accrued on such contributions made by the employer, if tax has been paid by the employer at 15% on such contributions made and the interest accruing thereon; and

(f) amount received from Employees' Trust Fund

Contribution or period of employment less than 20 years

Total Income from Employment (Rs)	Tax Payable
Upto 2,000,000	0%
2,000,001 – 3,000,000	5%
Exceeding 3,000,000	Rs. 50,000 +10% for Excess 3,000,000

Contribution or period of employment more than 20 years

Total Income from Employment	Tax Payable
Upto 5,000,000	0%
5,000,001 – 6,000,000	5%
Exceeding 6,000,000	Rs. 50,000 +10% for Excess 6,000,000

(4) The type of income referred to in subparagraph (2) (c) shall be income from a business consisting of betting and gaming, liquor or tobacco.

6.1.3 Tax rate for partnerships.

Where a partnership's taxable income includes gains from the realization of investment assets, those gains shall be taxed to the partnership at the rate of 10%.

6.1.4 Tax rates for trusts.

(1) Subject to the provisions of subparagraph (2), the taxable income of a trust for a year of assessment to which subsection (1) of section 56 applies shall be taxed at the rate of [24%].
(2) Where a trust's taxable income includes gains from the realization of investment assets, then –

(a) those gains, shall be taxed to the trust at the rate of 10%; and

(b) only the remainder of the trust's taxable income shall be taxed at the rate referred to in subparagraph (1).

(3) Where a trust's taxable income (not otherwise covered by this paragraph) includes gains from the realization of investment assets, those gains shall be taxed to the trust at the rate of 10%.

6.1.5 Tax rates for companies.

Description	Rate of Tax
Small and Medium Enterprises	14%
Predominantly (80%) conducting a business of exporting goods and services	14%
Predominantly (80%) conducting an agricultural business	14%
Predominantly (80%) providing educational services	14%
Predominantly (80%) engaged in an undertaking for the promotion of tourism	14%
Predominantly (80%) providing information technology services	14%
company with income from a business consisting of betting and gaming, liquor and/or tobacco	40%
Other than the above	28%

Qualifying information technology means –

(a) software development services; or

(b) the provision of information technology services under a business process outsourcing arrangement or a knowledge process outsourcing arrangement

Undertaking for the promotion of tourism means an undertaking for the operation of

(a) any hotel or guest house approved by the Ceylon Tourist Board;

(b) any restaurant graded by the Ceylon Tourist Board as being in "Class A" or "Class B";

(c) any business of travel agent who provides travel management services for domestic travel in Sri Lanka;

(d) any business of transporting tourists only; or

(e) any business approved by the Ceylon Tourist Board for providing facilities for recreation or sorts

(4) Where a company's taxable income includes gains from the realization of investment assets, then

(a) those gains, shall be taxed to the company at the rate of 10%; and

(b) only the remainder of the company's taxable income shall be taxed at the rate referred to in subparagraph (1).

6.1.6 Tax rates for unit trusts or mutual funds Sec 59(2)

(1) Unit trust's or mutual fund's taxable income taxed at the rate of 28%.
(2) Gains from the realization of capital assets taxed at the rate of 10%.

6.1.7 Tax rates for charitable institutions.

(1) The taxable income of a charitable institution, taxed at the rate of [14%].
(2) Gains from the realization of investment assets, the gains taxed at the rate of 10%;
(b) only the remainder of the charitable institution's taxable income shall be taxed at the rate referred to in subparagraph (1).

6.1.8 Tax rates for non-governmental organizations.

(1) The taxable income of a nongovernmental organization taxed at the rate of [28%].
(2) Gains from the realization of investment assets taxed at the rate of 10%
(3) The rate of tax payable by a non-governmental organization on amounts received in a year of assessment by way of grant, donation or contribution or in any other manner taxed at the rate of 28% (section 68)

6.1.9 Tax Rates for Employees Trust Funds, Provident or Pension Funds and Termination Funds.

(1) The taxable income of an employee's trust fund, an approved provident or pension fund, or an approved termination fund for a year of assessment shall be taxed at the rate of [14%].
(2) For this paragraph, "approved termination fund" means any thrift, saving or building society or welfare fund to which contributions are made by employees only or any gratuity funds approved by the Commissioner-General and maintained for the purposes of payment under the Payment of Gratuity Act, No. 12 of 1983, of gratuities to employees on the termination of their services.

6.1.10 Remittance tax rate.

The rate of tax payable by a non-resident person who has remitted profits taxed at the rate of 10% (section 62)

6.1.11 Withholding tax rates.

(1) The rates of tax to be withheld from payments shall be –
(a) for payments to which **section 83 applies** –
(i) in the case of a resident withholdee - at the rates specified by the Commissioner General and published in the Gazette; and
(ii) in the case of a non-resident withholdee - at the rates specified by the Commissioner General and published in the Gazette;
(b) for payments to which section **84(1)(a)(i) applies** –

(i) in the case of interest paid to a resident individual in relation to a bank deposit account (other than to an individual who is a senior citizen) - 5%;
(ii) in the case of interest paid to a senior citizen - at the rate and in the manner prescribed in regulations;
(iii) in the case of rent paid to a resident person – 10%; and (iv) in all other cases - 14%;
(c) for payments to which section 85 applies –

(i) in the case of service fees referred to in section 85(1)(a) - 5% on amounts exceeding Rs. 50,000 per month;
(ii) in the case of service fees referred to in section 85(1)(b) - 14%; and (iii) in the case of insurance premiums referred to in section 85(1)(b) - 14%.

(2) The rate of tax to be withheld from each partner's share of any partnership income under section 53(9) and section 84(1) (a) (ii) shall be 8% of the amount.

Tax payable by Withholding

Payment (source)	***Withholdee***	***WHT Rate***
Dividend	*Resident or Non – resident company*	*14%*
Interest from bank deposit	*Resident Individual who is a senior citizen*	*Exempt up to 1.5Mn*
	Resident Individual other than a senior citizen	*5% (final tax)*
	Non - resident Individual	*14% subject to DTA (final tax)*
	Charitable Institutions (resident)	*5% (final tax)*
	Clubs, associations, societies and other body of persons (resident)	*5% (WHT Credit)*
	EPF, ETF and approved termination fund (resident)	*5% (WHT Credit)*
	Resident Company	*5% (WHT Credit)*

6.2 Second Schedule - Investment Incentives

6.2.1. Enhanced Depreciation Allowances

A person who invest in Sri Lanka (other than the expansion of an existing business) during a year of assessment shall be granted enhanced capital allowances according to the below schedule, in addition to the claimed capital allowances.

Amount (USD)	Location/Purpose	%Allowance
Not exceeding 3Mn	Northern Province	200%
Not exceeding 3Mn	Other than Northern province	100%
3-100Mn	Other than Northern province	100%
Exceeds 100 Mn	Other than Northern province	150%
Exceeds 3Mn	Northern Province	200%

Exceeds 250Mn	Expenses incurred in the assets of a "state owned company" in any part of Sri Lanka.	150%

Enhance Depreciation Allowances incurred in respect of following depreciable assets, when expense not exceeding USD 3Mn

1 Plant and machinery used in manufacturing
2 Building, structures and similar works of a permanent nature.
3 Computer and data handling equipment together with peripheral devices.

6.1.2 Extended period for deducting unrelieved tax losses

Loss C/F period extended to 10 years to unrelieved Loss incurred due to Enhanced Depreciation Allowance claimed during a Year of Assessment.
Loss C/F period extended to 25 years where the enhanced depreciation allowance claimed is more than USD 1000 Mn or relates to investment in assets of a state owned company:

6.3 Third Schedule - Exempt Amounts

The following shall be exempt amounts:
(a) Employment income of the President;
(b) Amounts derived by –
(i) the Government of Sri Lanka
(ii) the Central Bank of Sri Lanka
(iii) any Government university,
(iv) Government assisted private school,
(v) cooperative society,
(vi) the Government of a foreign country or foreign territory to the extent specified under a diplomatic immunities law or a similar law;
(vii) an international organization to the extent specified under a diplomatic immunities law or a similar law or an agreement between the organization and the Government of Sri Lanka

(c) Capital sums paid to a person as compensation or a gratuity in relation to –
(i) personal injuries suffered by the person; or
(ii) the death of another person;

(d) the pension of a person, paid by the Government
(e) any amount paid to an employee at the time of retirement
(f) the income of an individual entitled to privileges to the extent provided for by –
(i) a diplomatic immunities law or a similar law;
(ii) Convention on the Privileges and Immunities of the United Nations and the Convention on the Privileges and Immunities of the Specialized Agencies of the United Nations
(iii) relating to an international organization

(g) a gain made by a resident individual in the year of assessment do not exceed Rs. 600,000

(h) a gain made by a resident individual on the realization of the individual's principal place of residence

(k) any prize received by a person as an award made by the President of Sri Lanka or by the Government in recognition of an invention created, or any research undertaken, by such person;

(l) any sum received by a person from the President's Fund

(m) an amount equal to the interest or the discount paid or allowed of any sovereign bond denominated in foreign currency

(**n**) any amount derived by a senior citizen from an annuity for life for a period of not less than ten years

(o) any winning from a lottery, the gross amount of which does not exceed Rs. 500,000;

(p) a dividend paid by a resident company to a member (subject to withholding under section 84)

(q) vehicle permit issued to that employee

(r) the profit or income from any property donated by royal or other grant before March2,1815

(s) dividends from and gains on the realization of shares in a non-resident company where derived by a resident company

(t) sale of any gem on which tax has been deducted under sec 84(2)

(a) the employment income of the President;

(b) amounts derived by –

(i) the Government of Sri Lanka or a local authority, including any Government department;

(ii) the Central Bank of Sri Lanka, including the Monetary Board;

(iii) any university under the University Act or the Buddhist and Pali University of Sri Lanka

(iv) any government assisted private school

(v) any registered societies like Co-operative societies

(vi) the Government of a foreign country or foreign territory to the extent specified under a diplomatic immunities law or a similar law

(vii) an international organization to the extent specified under a diplomatic immunities law or a similar law or an agreement between the organisation and the Government of Sri Lanka, provided that the exemption provided under the agreement shall be broader than that provided under diplomatic immunities law or a similar law;

(c) capital sums paid to a person as compensation or a gratuity in relation to –

(i) personal injuries suffered by the person

(ii) the death of another person

(d) the pension of a person

(e) any amount paid to an employee at the time of retirement from

(i) any pension fund or the Employees Trust Fund, for any period commencing on or after April 1, 1987, from investments made by it;

(ii) a provident fund approved by the Commissioner General

(f) the income of an individual entitled to privileges to the extent provided for by –

(i) a diplomatic immunities law or a similar law;

(ii) an Act giving effect to the Convention on the Privileges and Immunities of the United Nations and the Convention on the Privileges and Immunities of the Specialized Agencies of the United Nations; or

(iii) regulations made under this Act relating to an international organization, or a law or Act referred to in subparagraph (i) or (ii);

(g) a gain made by a resident individual in the year of assessment do not exceed Rs. 600,000

(h) a gain made by a resident individual on the realization of the individual's principal place of residence

(k) any prize received by a person as an award made by the President of Sri Lanka or by the Government in recognition of an invention created, or any research undertaken, by such person;

(l) any sum received by a person from the President's Fund

(m) an amount equal to the interest or the discount paid or allowed of any sovereign bond denominated in foreign currency

(**n**) any amount derived by a senior citizen from an annuity for life for a period of not less than ten years

(o) any winning from a lottery, the gross amount of which does not exceed Rs. 500,000;

(p) a dividend paid by a resident company to a member (subject to withholding under section 84)

(q) vehicle permit issued to that employee

(r) the profit or income from any property donated by royal or other grant before March2,1815

(s) dividends from and gains on the realization of shares in a non-resident company where derived by a resident company

(t) sale of any gem on which tax has been deducted under sec 84(2)

6.4 Fourth Schedule

DEPRECIATION ALLOWANCES, BALANCING ALLOWANCES AND ASSESSABLE CHARGES

Class	Depreciable Assets	No of Years
1	Computers and data handling equipment together with peripheral devices	5
2	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
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	5
4	Buildings, structures and similar works of a permanent nature	20
5	Intangible assets, excluding goodwill	useful life or 20 years

(2) Where a depreciable asset owned by a person is only partly used in the production of income from a business at the end of a 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 is used in the production of income from that business and that part not.

Depreciation allowances.

2. (1) Subject to this paragraph, an allowance shall be granted to a person for a year of assessment for each of the person's depreciable assets equal to the depreciation for the year of that asset and calculated in accordance with subparagraph (2).

(2) Depreciation for a year of assessment for each depreciable asset shall be calculated according to the straight line method using the following formula:

A/B

where

A is the depreciation basis of asset at the end of the year of assessment; and

B is the number of years referred to in subparagraph (3) applicable to that asset.

5 The actual useful life of the intangible asset, or where the intangible asset has an indefinite useful life.

(4) No depreciation allowance shall begranted to a person in respect of a road vehicle, other than –

(a) a commercial vehicle;

(b) a bus or minibus;
(c) a goods vehicle; or
(d) a heavy general purpose or specialised truck or trailer.
(5) For the purposes of this paragraph, "commercial vehicle" means –
(a) a road vehicle designed to carry loads of more than half a tonne or more than 13 passengers; or
(b) a vehicle used in a transportation or vehicle rental business.
Depreciation basis of a depreciable asset.
3. The depreciation basis of a depreciable asset of a person at the end of a year of assessment isshall bethe sum of –
(a) the 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.
Balancing allowances and assessable charges.
4. (1) Where a depreciable asset of a person is realised by the person before the end of a year of assessment
(a) an assessable charge is included in calculating the person's income for the year calculated in accordance with the following formula:
A – B
or
(b) a balancing allowance is granted to the person for the year calculated in accordance with the following formula:
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 realisation of the asset.
(2) For the purposes of this paragraph, "written down value" of an asset at the time of realisation of the asset means the expenses incurred by a person in acquiring the asset reduced by all depreciation allowances granted to the person under paragraph 2 in respect of the asset.
(3) For the purposes of this paragraph and without prejudice to section 39, a person realises a depreciable asset if the person sells the business in respect of which the expenses were incurred to another person who is not an associate.

6.5 Fifth Schedule - QUALIFYING PAYMENTS AND RELIEFS

1. The qualifying payments referred to in section 52 shall be as follows:
(a) a donation made by an individual or entity 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 –
(iia) in the case of an individual, one-third of the taxable income of the individual or Rupees seventy-five thousand, whichever is less;
(iib) in the case of an entity, one-fifth of the taxable income of the entity or Rupees five hundred thousand, whichever is less;
(b) a donation made by an individual or entity in money or otherwise to the following:
(i) the Government of Sri Lanka;
(ii) a local authority;
(iii) any Higher Education Institution established or deemed to be established under the Universities Act, No. 16 of 1978;
(iv) the Buddhist and Pali University or any Higher Educational Institution established by or under the Buddhist and Pali University Act, No. 74 of 1981;
(v) a fund established by the Government of Sri Lanka;
(vi) a fund established by a local authority and approved by the Minister;
(vii) the Sevana Fund created and administered by the National Housing Development Authority established by the National Housing Development Authority Act, No. 17 of 1979;
(viii) a fund established by a Provincial Council and approved by the Minister;
(ix) the Api Wenuwen Api Fund established by the Api Wenuwen Api Fund Act, No. 6 of 2008;
(x) National Kidney Fund established under the National Kidney Foundation of Sri Lanka (Incorporation) Act, No. 34 of 2006;
(c) 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.
2. The reliefs referred to in section 52 shall be as follows:
(a) Rs. 500,000 for each year of assessment, except that an individual who is a trustee, receiver, executor or liquidator shall not be entitled to deduct this personal relief as such trustee, receiver, executor or liquidator, and the relief is not available to be deducted against gains from the realization of investment assets;
(b) in the case of an individual with income from employment, Rs. 700,000 for each year of assessment, up to the total of the individual's income from employment for the year;
(c) in the case of an individual with rental income from an investment asset, an amount equal to 25 percent of the total rental income for the year of assessment, being a relief for the repair, maintenance, and depreciation relating to the investment asset, but shall only be allowed to the extent no deduction or cost is claimed for any actual expenditures incurred by the taxpayer for the repair, maintenance, and depreciation of the investment asset;

(d) in the case of an individual who is a senior citizen in a year with interest income derived from a financial institution, Rs. 1,500,000 for each year of assessment, up to the total of the individual's interest income for the year.

6.6 Sixth Schedule - TEMPORARY CONCESSIONS

Enhanced Depreciation Allowances

will apply only in the first 3 years from effective date of this Act.
1.The portion of gains and profits that is deemed as income of an insure engaged in the business of life insurance (i.e. surplus distributed to policyholder) taxed at 14%.
2 Double deduction for" research and development expenditure" (defined)
3 Headquarters relocated after 01.10.2017 as per IRD
4 Any person who has entered into a Standardized Power Purchase Agreement with CEB prior to 10.11.2016 to provide electricity generated from renewable resources-taxed at 14%.
5 A business predominantly engaged in the business of provision of "Information Technology" service (defined)and has at least 50 employees in the payroll-additional deduction of 35%of "personal cost" (defined).

Relevant Definitions.
"Small and Medium Enterprises" means a person who satisfies the following c

Entity	Gains from realization of investment assets	Other income
Unit trust /Mutual Fund	10%	28%
Unit Trust Management Company	10%	28%
Clubs, Societies And Associations	10%	28%

EPF, ETF Pension and retirement funds 14%(N) 10%(C)
Remittance of profits by non - residents
A non – resident person who carries on business in SL through a Permanent Establishment shall pay tax on the remitted profits earned within the Year of Assessment.
Tax Rate - 14%
Due date – within 30 days from the date of the remittance

Payment	withholder	New	Prevailing
Interest (other than the bank deposits) including discounts, Premium. Eg: Treasury bills and bonds, Corporate debt.	Resident/non resident	**Treasury bills and bonds-no WHT** (Implication for individuals :such income will now be liable at progressive rates up to a maximum of 24%) **Corporate debt** -5% for all the resident persons (final tax for individuals and charitable institutions, other entitled to WHT credit) -Non residents-14%(final tax)	10%(final tax for any person other than a company and WHT credit for companies)/ Exempt.

"depreciation allowance expenditure" means expenditure for which depreciation allowances are available under this Schedule; and
"written down value" of an asset means the cost of the asset less all depreciation allowances granted with respect to expenditure included in that cost.

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PART I : SECTION (I) — GENERAL

Government Notifications

INLAND REVENUE ACT, No. 24 OF 2017

Notice under paragraph 10(1)(b)(ii) of the First Schedule

REGULATIONS made by the Minister of Finance and Mass Media under Section 194 read with sub item (ii) of item (b) of sub paragraph (1) of paragraph 10 of the First Schedule of the Inland Revenue Act, No. 24 of 2017, on the deduction of income tax from interest payment to a senior citizen on money deposited in financial institutions. These Regulations are effective from April 1, 2018.

MANGALA SAMARAWEERA,
Minister of Finance and Mass Media.

Ministry of Finance and Mass Media,
Colombo 01,
01st April 2018.

REGULATIONS

a) Prescribe the rate under Part I of the Schedule ;

b) Prescribe the manner under Part II of the Schedule that any bank/financial institution shall withhold tax, when makes the interest payment to a senior citizen on money deposited.

SCHEDULE

PART I

Interest Income subject to Withholding Tax	*Withholding Tax Rate*
If the senior citizen declares that his/her total interest income derived from all financial institutions if any, exceeds Rs. 1,500,000 for a year of assessment, on the excess	5%

PART II

- **Declaration**

The senior citizens should provide a declaration as per the following format, in each year of assessment for each account maintained in a financial institution.

- **False or Misleading Statement**

A declaration, statement or certificate provided by a senior citizen to a financial institution is treated as a statement made to a tax official for the purpose of section 181 of the Act.

Department of Inland Revenue

To : .....

.....

.....

.....

(Name and address of the Financial Institution)

Account No. :.....

Year f assessment :.....

Declaration (By Senior Citizens)

I,.....

.....(Full Name)

of.....(Address)

hereby declare that ;

I am a resident and a senior citizen of Sri Lanka (as per the provisions of the Inland Revenue Act, No. 24 of 2017)

1. The aggregate ineterest receivable by me for the above year of assessment on the monies deposited in this account or any other account of this bank or any other accounts in any other bank or any other financial institution does not exceed Rs. 1,500,000/-. Therefore, please refrain from deducting withholding tax on the interest payable on this account.

2. The aggregate of the interest receivable by me on the monies deposited in the above account together with the total interest receivable by me from any other account of this bank and of any other account in any other bank or any other financial institution may exceed Rs. 1,500,000/- of total interest for the above year of assessment. Therefore, place withhold the tax on the excess of the interest over Rs.....

3. The tax relief on interest income of Rs. 1,500,000/- which is available to senior citizen has been availed by me in respect of the interest receivable by me on the monies deposited in the other accounts of this bank or other banks or other financial institutions. Therefore, please withhold tax on the total interest receivable by me from this account.

National Identity Card No.....

Tax payer Identification No.....

I certify that the above declaration made by me is true and correct.

Any changes to my residence status will be notified to the bank at the time of such change.

....
Date Signature of the Declarent.

(*please strike-off the statements not relevant)

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PART I : SECTION (I) — GENERAL

Government Notifications

INLAND REVENUE ACT, No. 24 OF 2017

By virtue of the powers vested in me under Section 194 of the Inland Revenue Act, No. 24 of 2017, I, Mangala Samaraweera, Minister of Finance and Mass Media, do by this order prescribe, for the purpose of section 85 as in the regulation hereto. These regulations are effective from April 1, 2018.

MANGALA SAMARAWEERA,
Minister of Finance and Mass Media.

Ministry of Finance and Mass Media,
Colombo 01,
April 01, 2018.

REGULATIONS

1. The following services are prescribed for the purpose of sub paragraph (v) of paragraph (a) of sub section (1) of section 85, as being the services rendered with a source in Sri Lanka and pays to a resident individual being :

   (i) any service provided in the capacity of independent service providers such as doctors, engineers, accountants, lawyers, software developers, researchers, academics, or any other similar service ;

   (ii) any service of construction work, security service, janitorial service, consultation work of any kind, organizing of events, catering, designers, dress makers, tour guidance, entertainment, agency functioins or any similar services or connected work where such services are provided under an agreement or otherwise ;

   (iii) any management service ;

   (iv) any type of vocational services provided as an independent service provider.

2. The rate of 2% is prescribed for the purpose of paragraph (b) of sub section (2) of section 85 of the Act, when a resident person makes a payment to a non-resident person.

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PART I : SECTION (I) — GENERAL

Government Notifications

INLAND REVENUE ACT, No. 24 OF 2017

Notice under Paragraph (e)(iii) of the Third Schedule

REGULATIONS made by the Minister of Finance and Mass Media under subparagraph (iii) of paragraph (e) of Third Schedule of Inland Revenue Act, No. 24 of 2017. These Regulations are effective from April 1, 2018.

MANGALA SAMARAWEERA,
Minister of Finance and Mass Media.

Ministry of Finance,
Colombo 01,
01st April 2018.

REGULATIONS

The official emoluments of any individual who is employed by the Asian Develoment Bank, shall for the purposes of Third Schedule of the Inland Revenue Act, No. 24 of 2017 be exempt amounts.

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PART I : SECTION (I) — GENERAL

Government Notifications

INLAND REVENUE ACT, No. 24 OF 2017

Regulations under Section 194

REGULATIONS made under Section 194 of the Inland Revenue Act, No. 24 of 2017, for the purpose of that Act. These Regulations are effective from April 1, 2018.

MANGALA SAMARAWEERA,
Minister of Finance and Mass Media.

Ministry of Finance and Mass Media,
Colombo 01,
01st April 2018.

REGULATIONS

TRANSITIONAL PROVISIONS

(1) The Inland Revenue Act, No. 10 of 2006 shall not apply to any income tax, for any year of assessment commencing on or after April 1, 2018, unless otherwise stated in the Inland Revenue Act, No. 24 of 2017 or as regulated in the succeeding provisions.

(2) Where the whole or any part of the profits and income of a person is exempt from income tax under the provisions of sections 16C, 16D, 16E, 17, 17A, 18, 20, 24A, of the Inland Revenue Act, No. 10 of 2006, for a period as specified in those provisions and, if there is any unexpired part of that period as at March 31, 2018, such part shall continue to be exempt from income tax as if such provisions continued to have application.

(3) If-

(a) an enterprise has entered into an agreement with the Board of Investment of Sri Lanka under section 17 of the Board of Investment of Sri Lanka Law No. 4 of 1978 prior to April 1, 2018 ; and

(b) the agreement provides for the profits and income of that enterprise to be fully or partly exempt from income tax or to be taxed at reduced rate of income tax, under the Inland Revenue Act, No. 28 of 1979 or

under the Inland Revenue Act, No. 38 of 2000 or under the Inland Revenue Act, No. 10 of 2006 as the case may be, or for the basis for the computation of income tax liability,

such profit and income of such enterprise shall continue to be exempt from icome tax payable under the Inland Revenue Act, No. 24 of 2017 or liable for income tax calculated on the basis and at the rate provided under that agreement.

(4) Where the whole or any part of the profits and income of a person is entitled to pay tax of concessionary rate under provisions 59D, 59I, 59J, 59K, 59L, 59M of the Inland Revenue Act, No. 10 of 2006, for a period as specified in those provisions and, if there is any unexpired part of that period as at March 31, 2018, such period shall continue.

(5) Where any provision of the Inland Revenue Act, No. 10 of 2006 provides for the deduction of any loss in ascertaining the assessable income of any person for any year of assessment, and any balance of such loss as at March 31, 2018, shall deemed to be the loss incurred 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.

(6) Where section 34 of the Inland Revenue Act, No. 10 of 2006 provides for the deduction of any allowances in ascertaining the taxable income of any person for any year of assessment, and any balance of such allowance as at March 31, 2018, shall subject to any conditions specified in the provisions enabling such deductions, be deductible from the taxable income of that person in any year of assessment commencing on or after April 1, 2018, as if such provision continued to have application.

(7) The allowance for depreciation in respect of any -

(a) capital asset acquired prior to April 1, 2006, any qualified building constructed or any building acquired prior to April 1, 2006 ; or

(b) 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.

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

(8) Any profit, loss, receipt or payment in respect of any finance lease agreement entered into, prior to April 1, 2018, shall be computed in accordance with the respective provisions of the Inland Revenue Act, No. 10 of 2006.

(9) The following types of entities or activities approved by the Minister or the Commissioner-General under any provision of the Inland Revenue Act, No. 10 of 2006 shall be deemed to have been approved by the Minister or by the Commissioner-General, as the case may be, under the respective provisions of the Act :

Type of Entity or Activities	*Approved by*
Provident or saving society	Minister
Activity being of humanitarian in nature	
Charitable institution established for the provision of institutionalized care for the sick or the needy	

Type of Entity or Activities	*Approved by*
Provident fund	Minister or Commissioner-General
Pension or saving fund	
Gratuity fund	
any accountant or any individual (for the purpose of the definition of authorized representative)	Commissioner-General

(10) The carried forward Notional Tax credit as per section 138(2) of Inland Revenue Act, No. 10 of 2006 may be carried forward to be set off against the income tax liability within three consecutive years of assessment commencing from the year of assessment 2018/2019.

(11) In case of any dividend paid to be shareholder of any company prior to April 01, 2019, out of any such dividend received by that company from any other company on which tax had been deducted prior to April 01, 2018 in accordance with the provisions of the Inland Revenue Act, No. 10 of 2006, such dividend shall not be subject to tax under the provisions of the Inland Revenue Act, No. 24 of 2017.

(12) In case of any non-resident person whose profit from any project in Sri Lanka has been ascertained by the Commissioner General of Inland Revenue, in accordance with the section 83 of the Inland Revenue Act, No. 10 of 2006, prior to April 01, 2018, as a percentage of the sum receivable from trade or business of such person, such percentage of the sum receivable from that project shall be continued for any year of assessment commencing from April 01, 2018.

(13) Where a direction is issued by the Commissioner General of Inland Revenue under Section 28 of the Inland Revenue Act, No. 10 of 2006, such direction shall continue to be in force.

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The Gazette of the Democratic Socialist Republic of Sri Lanka
EXTRAORDINARY

අංක 2064/55 - 2018 අප්‍රේල් මස 01 වැනි ඉරිදා - 2018.04.01
No. 2064/55 - SUNDAY, APRIL 01, 2018

(Published by Authority)

PART I : SECTION (I) — GENERAL

Government Notifications

INLAND REVENUE ACT, No. 24 OF 2017

Notice under Sections 18

BY virtue of the powers vested in me under Section 18(4) of the Inland Revenue Act, No. 24 of 2017 in relation to the circumstances in which losses on financial instruments may only be set against gains on financial instruments, I, Disanayake Mudiyanselage Lalith Ivan Disanayake, Commissioner General of Inland Revenue, do by this notice specify any circumstance in which loss on a financial instrument is occurred as the circumstance in which loss on a financial instrument set against the gain from same type of financial instrument.

D. M. L. I. DISANAYAKE,
Commissioner General of Inland Revenue.

Department of Inland Revenue,
Colombo 02,
01st April 2018.

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No. 2064/56 - SUNDAY, APRIL 01, 2018

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PART I : SECTION (I) — GENERAL

Government Notifications

INLAND REVENUE ACT, No. 24 OF 2017

Notice under Section 31(3)

BY virtue of the powers vested in me under Section 31(3) of the Inland Revenue Act, No. 24 of 2017 in relation to the any period for which interest on a blended loan is compounded, I, Disanayake Mudiyanselage Lalith Ivan Disanayake, Commissoner General of Inland Revenue, do by this notice specify any other period which is considered by the generally accepted accounting principles.

D. M. L. I. DISANAYAKE,
Commissioner General of Inland Revenue

Department of Inland Renenue,
Colombo 02,
01st April 2018.

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No. 2064/57 - SUNDAY, APRIL 01, 2018

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PART I : SECTION (I) — GENERAL

Government Notifications

INLAND REVENUE ACT, No. 24 OF 2017

Notice under Section 66

BY virtue of the powers vested in me under Section 66(2) of the Inland Revenue Act, No. 24 of 2017 in relation to specific provision for a debt claim made by a person conducting a banking business, I, Disanayake Mudiyanselage Lalith Ivan Disanayake, Commissioner General of Inland Revenue, do by this notice specify the specific provision for a debt claim in accordance with the relevant directives made by the Central Bank of Sri Lanka subject to conditions as set out in the Schedule.

D. M. L. I. DISANAYAKE,
Commissioner General of Inland Revenue

Department of Inland Revenue,
Colombo 02,
01st April 2018.

Schedule

(1) No provision made in respect of potential risk of credit facilities in accordance with the relative directives made by the Central Bank of Sri Lanka.

(2) No provision made in respect of pawing debtors in the business of pawn broking carried on by a Financial Institutions in accordance with the relative directives made by the Central Bank of Sri Lanka.

(3) No provision made in respect of a debt claim given to an associated person.

(4) No provision made in respect of a debt claim given to a person outside Sri Lanka.

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No. 2064/58 - SUNDAY, APRIL 01, 2018

(Published by Authority)

PART I : SECTION (I) — GENERAL

Government Notifications

INLAND REVENUE ACT, No. 24 OF 2017

Notice under Section 115

BY virtue of the powers vested in me under Section 115 of the Inland Revenue Act, No. 24 of 2017, I, Dissanayake Mudiyanselage Lalith Ivan Dissanayake, Commissioner General of Inland Revenue, do by this notification specify the circumstances under which a tax payer may designate an authorized representative to communicate with the Inland Revenue Department on behalf of the tax payer as set out in the Schedule hereto effective from 01.04.2018.

D. M. L. I. DISSANAYAKE,
Commissioner General of Inland Revenue.

Department of Inland Renenue,
Colombo 02,
01st April 2018.

Schedule

01. For the purpose of having all kinds of corresponding with the Department relating to tax payer registration and tax type registration in terms of Section 102.

02. For the purpose of notifying any change in the particulars of tax payer profile in terms of Section 103(5) of the Act.

03. For the purpose of applying for private rulings in terms of Section 107 on behalf of the tax payer and to maintain all kinds of corresponding relating to it.

04. For the purpose of requesting and receiving any information in terms of Section 118 to be provided by the Commissioner General.

05. For the purpose of furnishing any information required by an Assistant Commissioner or to appear at the time and place designated in a notice for any other required purpose in terms of Section 123 of the Act.

06. For the purpose of filing tax returns, additional returns and information returns as required by chapter XI to the Act.

07. For the purpose of requesting to make amendments to self-assessment return in terms of Section 136 of the Act.

08. For the purpose of forwarding applications for administrative reviews, represent the taxpayer at the reviews conducted by Commissioner General, forwarding written submissions where necessary and entering into settlement in that regard with Commissioner General on behalf of the tax payers.

09. For the purpose of applying for extension of time for filing returns in terms of Section 130 of the Act and extension of time for payment in terms of Section 151 of the Act.

10. For the purpose of applying for refundable amounts and to make all sort of corresponding in that regard in terms of Section 150 of the Act with the Department.

11. For the purpose of representing the taxpayer in any kind of investigation conducted by the Commissioner General in terms of Section 186 of any offence chargeable under this Act.

12. For the purpose of filing capital gain tax return in terms of Section 93(3) of the Act on behalf of the tax payer.

13. For the purpose of representing the taxpayer in any other case where the representative is specifically being authorized in writing by the tax payer.

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Circular No: SEC/2018/.01 Date: 16.03.2018

Circular to Banks / Financial Institutions

Withholding Tax on Interest paid by Banks or other Financial Institutions

This Circular sets out explanatory notes and guideline to any Bank or Financial Institution, to facilitate the application of section 84 of the Inland Revenue Act, No. 24 of 2017, with effect from April 1, 2018, for the deduction of income tax from interest, discount or income from Islamic financial transaction referred to in section 32 payable or paid by such Bank or Financial Institution to **any person** (person includes individual, , company or body of persons, trust , association or charitable institutions etc.), on any sum of money deposited or invested as the case may be; with **Sri Lankan rupees or any other foreign currency.**

1. Time of Deduction

Tax should be withheld at the time, the interest/ discount/profit is paid or credited, reinvested, accumulated or capitalized; as the case may be; to any account maintained in a Bank or Financial Institution by a person or on behalf of such person including interest accrued to foreign currency accounts. In case of foreign currency account, the exchange rate should be the rate in which the withholding is due.

2. Circumstances for non-reduction of withholding tax

(I) The tax deduction required under the provisions of section 84 of the Act, is not applicable to the following interests or discounts.

a. Interest paid to a financial institution on the ordinary loans and advances provided by such institution;

b. Interest or discount paid to any person on Security or Treasury Bond under the Registered Stocks and Securities Ordinance (Chapter 420) or Treasury Bill under the Local Treasury Bills Ordinance (Chapter 417);

c. An amount equal to the interest or the discount paid or allowed, as the case may be, to any non-resident person or to any licensed commercial bank in Sri Lanka, by the issuer of any sovereign bond denominated in foreign currency, issued on or after October 21, 2008, by or on behalf of the Government of Sri Lanka;

d. Aggregated interest income (from all deposits) of a senior citizen (resident in Sri Lanka who is sixty years old or above at any time during the year of assessment) up to Rs. 1.5 Million per annum (subject to declaration of such senior citizen as per the format given in Annexure 1).

e. The interest derived by a charitable institution, where it is proved to the satisfaction of the Commissioner-General that such interest is applied solely for the purpose of providing care to children, the elderly or the disabled in a home maintained by such charitable institution;

(Any Financial institution is required to seek confirmation from the Department of Inland Revenue that such institution is qualified for this exemption)

(II) Any interest payable to:

(a) the Government of Sri Lanka or a Local Authority including any government department;

(b) the Central Bank of Sri Lanka including Monetary Board;

(c) any university established under any university Act in Sri Lanka;

(d) Government assisted any private school registered with the Ministry of Education and mandated to follow the Government circulars;

(e) Co-operative Societies registered under Co-operative Societies Law, No. 5 of 1972;

(f) a foreign Government which falls under a diplomatic immunities law;

(g) any international organization which falls under a diplomatic immunities law or similar law or exemption provided under an agreement entered into with Government of Sri Lanka;

(h) an individual entitled to privileges to the extent for by-

(i) a diplomatic immunities law or a similar law;

(ii) an act giving effect to the Convention on the Privileges and Immunities of the United Nations or specialized Agents of the United Nations;

is not liable for the deduction of withholding tax.

3. Rates of Deduction

Every Bank or Financial Institution paying interest including any sum referred to as "excess" over the original payment (in the case of any certificate of deposit), discount or profit from Islamic financial transaction is required to withhold income tax from such payment (unless it is exempt) as follows:

(i) in the case of interest or discount or income from Islamic financial transaction **paid to any person** (other than to a senior citizen), is required to withhold at the rate of 5%;

(ii) in the case of a senior citizen, if the interest income exceeds Rs. 1,500,000 for any year of assessment, the liability to withholding tax arises on the balance of the interest income for the year, and be withheld at the rate of 5%;

Notes:

(a) If a direction has been issued by the Commissioner General of Inland Revenue or any officer authorized by the Commissioner General (as referred to in paragraph 5), the deduction should be made in accordance with such direction, and such directions should be kept in safe and be made available to any officer authorized by the Commissioner General for inspection (if required);

(b) As per the section 195 (interpretation) of Inland Revenue Act, **"Person"** means an individual or **entity** and includes a body of persons corporate or unincorporated, an executor, non-governmental organization and charitable institution. Further, **"entity"** means a company, partnership or trust, but excludes an individual.

4. Joint Accounts

Interest on joint accounts of individuals may be apportioned among such individuals according to the mandate given to the Bank or Financial Institution and such part of the interest apportioned to each such individual can be treated as interest payable to such individual.

5. Direction for Charitable Institution

If the recipient of the interest is a charitable institution and has reasons to believe that income tax payable/ computed by such recipient for any year of assessment, is exempt under section 9 of the Act, such a recipient may request direction from the Commissioner General. The Bank/ Financial Institution should honor any such direction issued by or under the authority of the Commissioner General, and make adjustment accordingly.

6. Certificate of Deduction

Every Bank or Financial Institution deducting income tax accordance to paragraph 3 is required to issue in respect of each deduction, a certificate of tax deduction to every depositor (individual, partnership, company or body of person etc.), in the following format. **The withholding certificate shall cover a calendar month and shall be served within 30 days after the end of the month.**

Note: If a withholding tax deduction is **duly made** from the interest on any deposit of resident individual or charitable institution, taxation of such interest is treated as final.

7. Records to be maintained by the Bank/ Financial Institution and their other obligations

Every Bank and Financial Institution is required to –

(a) Register as withholding agent under the requirements of Commissioner General of Inland Revenue.

As per section 195;

"withholding agent" means a person required to withhold tax from a payment under the Inland Revenue Act.

"withholdee" means a person receiving or entitled to receive a payment from which tax is required to be withheld under the Inland Revenue Act;

(b) As provided in section 102 of the Inland Revenue Act, Banks or Financial Institutions (withholding agent) liable to furnish return of income for a year of assessment is required to obtain a registration number from the Commissioner General not **later than 30 days prior to the commencement of deduction of tax.**

(c) According to the section 86 of the Inland Revenue Act, every withholding agent shall file with the Commissioner General within 30 days after the end of each year of assessment.

Keep a proper record of the interest/excess amount as the case may be, paid by a Bank or Financial institution any year of assessment to any person and the date or dates on which such interest or excess is paid, as per the format given in the Annexure 3.

(f) Keep a record of interest on which no withholding tax has been deducted due to exemption from deduction as mentioned in paragraph 2 of this guideline as per the format given in Annexure 4.

Note: Commissioner General of Inland Revenue may permit officer of the Department authorized (in writing) to inspect the above records.

8. Payments of tax withheld or treated as withheld

(i) Every withholding agent must pay to the Commissioner-General within 15 days after the end of each calendar month any tax that has been withheld in accordance of the paragraph 3, during the month. The monthly payment of the relevant tax, should be credited to the People's Bank Account No. 014-1002-6-9026620 through the paying-in-slip issued by the Department (Which have DLN Number) ,

(ii) A withholding agent, who fails to withhold tax in accordance with the provisions of Division II of Chapter VIII of the Inland Revenue Act, must nevertheless pay the tax that should have been withheld in the same manner and at the same time as tax that is withheld.

9. Submission of Returns and Schedules

(i) Return

Every withholding agent for any year of assessment commencing on or after April 1, 2018, duly prepared **annual return** which are issued by the Commissioner General of Inland Revenue, should file with the Commissioner General within 30 days after the end of each year ending on 31st day of March,

Please note that Photostat copies of the return issued by the Department of Inland Revenue will not be entertained. Further, return should be furnished even in the instances where no any tax is payable.

(ii) Schedules

Please note that with effect from April 1, 2018, schedules should be submitted on withholding tax deducted on interest paid or credited or discount allowed or on any charge, referred to in section 84 of the Inland Revenue Act, as per the formats given in Annexure 3 & Annexure 4.

Note: The schedules are required to be furnished in (Excel csv format) electronic form. However, if numbers of tax payers are less than 20, hard copies may be submitted.

D.M.L.I. Dissanayake
Commissioner General of Inland Revenue

Ivan Dissanayake
Commissioner General of Inland Revenue
Department of Inland Revenue
Sir Chittampalam A Gardiner Mawatha
Colombo 02

Annexure 1

DEPARTMENT OF INLAND REVENUE

To: .....

.....

.....

.....

(Name & address of the Financial Institution)

Account No.: .....

Year of assessment: .....

DECLARATION (BY SENIOR CITIZENS)

I,

.....

(Full Name)

of..... *(Address)*

hereby declare that;

I am a resident and a senior citizen of Sri Lanka (as per the provisions of the Inland Revenue Act No. 24 of 2017)

1. The aggregate interest receivable by me for the above year of assessment on the monies deposited in this account or any other account of this bank or any other accounts in any other bank or any other financial institution does not exceed Rs. 1,500,000/-. Therefore, please refrain from deducting withholding tax interest payable on this account.

2. The aggregate of the interest receivable by me on the monies deposited in the above account together with the total interest receivable by me from any other account of this bank and of any other account in any other bank or any other financial institution may exceed Rs. 1,500,000/- of total interest for the above year of assessment. Therefore, please withhold the tax on the excess of the interest over Rs.....

3. The tax relief on interest income of Rs. 1,500,000/- which is available to senior citizen has been availed by me in respect of the interest receivable by me on the monies deposited in the other accounts of this bank or other banks or other financial institutions. Therefore, please withhold tax on the total interest receivable by me from this account.

National Identity Card No. .....

Tax payer Identification No. .....

I certify that the above declaration made by me is true and correct.

Any changes to my residence status will be notified to the bank at the time of such change.

....

Date **Signature of the Declarant**

(please strike-off the statements not relevant)*

Annexure 2

Certificate No:/ Serial No:

Withholding Agent TIN:

Certificate of Tax Deduction

Name and address of the Bank/Financial Institution: .....

Name and address of the Depositor: .....

National Identity Card No. /Passport No. / Tax Identification No.: .....

Period: from: ..... to: .....

(a) Gross amount of the interest (Rs,): .....
(b) (i) Rate of tax: .....
(ii) Amount of tax deducted (Rs.): .....
(c) Date of tax deduction .....

....

Name of the Authorized Officer Signature of the Authorized Officer

Date: .....

Annexure 3

Schedule 1- WITHHOLDING TAX FROM INTEREST

Withholding tax deducted from any person should be declared in the following schedule.

1	2	3	4	5	6	7	8	9	10	11	12	13	14
Serial No	**Type**	**Name**	**Address**	**TIN / Passport No/ NIC. No**	**Account No / Certificate No**	**Date of Commencement of Deposit/ Investment (YYYY-MM-DD)**	**Date of Maturity (YYYY-MM-DD)**	**Account Value / Investment Value (Rs)**	**Interest Rate (%)**	**Interest paid/ payable (Rs)**	**Rate of WHT (%)**	**WHT (Rs)**	**WHT Certificate No**
Total													

Annexure 4

Schedule 2 – DETAILS OF WITHHOLDING TAX EXEMPTIONS

The exemptions from deduction stated under paragraph 2, should be declared in the following schedule.

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Serial No.	Type	Branch Code	Name of the Recipient of the Interest	NIC No./ TIN	Amount of Interest Paid	Reason for exemption
Total						

The following table provides illustration for types & exemptions.

Examples for Type	**Examples for Reasons for exemption**
Fixed Deposits	Ordinary loans
Savings Accounts	Senior Citizen
Foreign Currency Accounts	Charitable Institution
Certificate of Deposit	Treasury Bill
Corporate Debt Securities	Treasury Bond
Government Securities	sovereign bond
Others	Other

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உள்நாட்டு இறைவரித் திணைக்களம்
DEPARTMENT OF INLAND REVENUE

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செயலகம்
14 வது மாடி
உள்நாட்டு இறைவரிக் கட்டிடம்
சேர் சிற்றம்பலம் ஏ காடினர் மாவத்தை
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E-Mail – secretariat@ird.gov.lk
Web: www.ird.gov.lk

SEC 2018/02

27th March 2018

Circular to Banks, Financial Institutions and Remitters of Foreign Exchange

Collection of Remittance Fee (RF) on the Inward Remittance of Foreign Exchange as Enacted in the Foreign Exchange Act No. 12 of 2017

A remittance fee has been introduced on the inward remittances of foreign exchange by the Foreign Exchange Act No. 12 of 2017. The Act has come into operation with effect from November 20, 2017 as notified in the Extraordinary Gazette No. 2043/31 published on October 31, 2017.

In terms of section 8(3) of the Act, any Sri Lankan citizen resident in Sri Lanka (hereinafter referred to "person") who remits to Sri Lanka any foreign exchange exceeding the value of one million United States dollars (or equivalent in other currencies) which have not been declared to the Commissioner General of Inland Revenue or the Head of the Department of Foreign Exchange before November 20, 2017 and which are not the property in respect of which proceedings are pending in a court of law or an order has been made by a court of law under any of the following Acts;

a. Prevention of Money Laundering Act, No. 5 of 2006,
b. Convention on the Suppression of Terrorist Financing Act, No. 25 of 2005 or
c. the Bribery Act (Chapter 26);

shall be liable to pay a remittance fee of one per centum to the Commissioner General of Inland Revenue except the person who invests such foreign exchange in Sri Lanka Development Bonds issued by the Government of Sri Lanka.

Any person remits foreign exchange not exceeding one million United States dollars (or equivalent in other currencies) shall not be liable to pay the remittance fee.

Accordingly, any such person who intends to seek immunity under section 8(3) of the Act on his/her remittance to Sri Lanka an amount of foreign exchange at any value must have obtained the approval of the Commissioner General of Inland Revenue prior to the remittance.

In order to obtain the "Approval of the Commissioner General of Inland Revenue", following procedures must be followed by such persons.

i. Must have obtained a Taxpayer Identification No (TIN)
Primary Registration Unit (Ground Floor) of the Inland Revenue Department (IRD) will issue the TIN on submission of the required documents for registration.

ii. Should make a declaration to the Commissioner General
Declaration should be made in the specified form prescribed by the Commissioner General (as in the Annexure) and submitted to the **Secretariat** of the IRD along with a letter confirming the value of the foreign exchange, country of origin etc from prospective bank by which the remittance of foreign exchange is to be received.

iii. Should make the due "Remittance Fee", if such fee is applicable
In case of any person who shall be liable to pay the Remittance Fee, such person should have made the payment of remittance fee at 1% of such remittance applying the currency (Sri Lankan Rupees) rate as at the date of payment by **cash/bank draft** using the "Remittance Form" to any branch of **Bank of Ceylon**.

If the fee is intended to be made by a bank draft, such bank draft should be drawn in favour of the Commissioner General of Inland Revenue, stating the **Account No. 2026460 of Bank of Ceylon.**

When filling the Remittance Form to pay the remittance fee, please apply the followings (among others stated in the reverse of the form).

- Tax type code - | 2 | 4 |
- Payment Period - | 1 | 8 | 1 | 9 | 0 |

In case of any person who intends to invest his/her inward remittance which exceeds the value of one million United States dollars (or equivalent in other currencies) in Sri Lanka Development Bonds issued by the Government of Sri Lanka, such person should prove to the Commissioner General soon after the investment is made that such foreign currency is invested in such bond.

Furnishing of incorrect information, false statement in the Declaration, non furnishing of any information with regard to remittances, failure to prove the investment in Sri Lanka Development Bonds (if applicable) shall lead to revoke the immunity obtained under provisions of the Act.

Ivan Dissanayake
Commissioner General of Inland Revenue

Ivan Dissanayake
Commissioner General of Inland Revenue
Department of Inland Revenue
Sir Chittampalam A Gardiner Mawatha
Colombo 02

Annexure

Declaration of Inward Remittance of Foreign Exchange
[Section 8(3) of the Foreign Exchange Act No. 12 of 2017]

(A) Personal Information

1. Full Name of the Declarant:.....
2. Address : .....
   .....
3. NIC No.: .....
4. Passport No.: .....
5. Taxpayer Identification No. (TIN) :.....

(B) Remittance Detail

6. Value of foreign exchange intended to remit to Sri Lanka : US $.....
   In words: .....
   .....
7. Name of prospective bank by which the remittance of foreign exchange to be received: .....
8. Country of origin from which the foreign exchange to be remitted: .....

(C) Declaration Detail

9. Have you made any Declaration ever before to the Commissioner General of Inland Revenue (CGIR) or the Head of the Department of Foreign Exchange (HDFE) in connection to above foreign exchange: **Yes/No**

10. If yes, detail of such declaration (attach evidence):
    Whether the Declaration was made to CGIR/HDFE (delete where inapplicable)
    i. Date of declaration: .....
    ii. Year of Assessment: .....
    iii. Name of the financial institution by which the remittance of foreign exchange was received: .....
    iv. Value of foreign exchange: US $.....
    (In words).....
    .....

11. Is any proceeding pending in a court of law or an order has been made by a court of law under any of the following Acts in connection to above foreign exchange;
    a. Prevention of Money Laundering Act, No. 5 of 2006 : Yes/No
    b. Convention on the Suppression of Terrorist Financing Act, No. 25 of 2005: **Yes/No**
    c. the Bribery Act (Chapter 26) : **Yes/No**

    If yes, give detail (attach evidence): .....

    .....

    .....

12. Do you invest such foreign exchange in a development bond issued by the Government of Sri Lanka (Documents must be submitted subsequent to the investment is made), If so, give detail: .....

    .....

(D) Remittance Fee Detail (attach evidence)

13. Liability to Remittance Fee @ 1% in US$.....
14. Currency rate as at the date of payment Rs. .....
15. Payment details
    a. Amount of remittance fee paid: Rs. .....
    b. Date paid:.....
    c. Bank Branch: .....

I declare that all particulars furnished in this Declaration are true and correct to the best of my knowledge and belief. I am aware that making an incorrect or false statement or giving false information in relation to this Declaration shall lead to revoke any immunity granted under section 8(3) of the Foreign Exchange Act No. 12 of 2017.

.....

Date:..... Signature of Declarant

Telephone (Fixed) No.....

Mobile: .....

E-Mail: .....

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உள்நாட்டு இறைவரித் திணைக்களம்
DEPARTMENT OF INLAND REVENUE

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14 වන මහල
දේශීය ආදායම් ගොඩනැගිල්ල
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කැ.පෙ. 515, කොළඹ 2- ශ්‍රී ලංකාව

செயலகம்
14 வது மாடி
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சேர் சிற்றம்பலம் ஏ காடினர் மாவத்தை
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Secretariat
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දුරකථන/ தொலைபேசி / Telephone - 011- 2135400 / 2135402
E-Mail – cgir@sltnet.lk
Web: www.ird.gov.lk

My No: SEC/2018/03

March 29, 2018

Chief Executive Officers / General Managers/ Country Heads of Commercial Banks and Specialized Banks

Dear Sir/ Madam,

Furnishing of Tax Clearance Certificate to Banks

Please be informed that the circular issued on 16.11.2017 in respect of outward remittances made by commercial banks and authorized dealers have been revised. Therefore, you are kindly requested to comply with this circular with immediate effect.

As per the Exchange Control Act, remitter may be permitted to make outward remittances, but in order to comply with the provisions of the Inland Revenue Act; a clearance should be obtained from the Commissioner General unless the purpose of such remittance is either under any occasion as set out below or for import of any tangible good.

A clearance certificate is not required in relation to following remittances.

(i) Remittances of sale proceeds of quoted shares owned by non–residents in companies resident in Sri Lanka.

(ii) Remittances of dividends paid to non-resident shareholders if Withholding Tax on dividends has been paid.

(iii) Foreign investments made by resident companies of Sri Lanka in line with the guideline issued by the Central Bank of Sri Lanka (CBSL).

(iv) Transportation expenses in relation to freight forwarding, courier services and airline services involving the carriage of passengers and goods, subject to submission of an annual clearance certificate obtained from the Commissioner General (for this

purpose the annual clearance is issued based on the financial statements of accounts submitted with the return of income for the previous year of assessment).

(v) Payments to employees including directors of the companies of wages, salaries and other benefits which have been subjected to tax under the PAYE Scheme (T10 Certificate or salary slip issued for the purpose of Stamp Duty Act has to be produced in proof of deduction of PAYE Tax). If the T10 certificate or salary slip is not produced, it is required to submit a copy of the clearance certificate obtained by the employer from the Commissioner General on behalf of such employees with regard to the exemption on the employment income.

(vi) Remittances by export companies in respect of services in relation to advertising (subject to periodical clearance from the Inland Revenue), sales promotion, marketing and trade fairs performed outside Sri Lanka.

(vii) Remittances by export companies in respect of registration of trademarks outside Sri Lanka.

(viii) Remittances in relation to annual subscription for membership of professional bodies, or periodical subscription for journals, magazines and other publication.

(ix) Remittances made in relation to course fees, examination fees, enrolment fees, living expense and payments of similar nature in respect of students.

(x) Remittances in respect of visa expenses, medical expenses, air travel expenses and expenses on hotel accommodation abroad.

(xi) Capital repayment of foreign loans obtained by resident companies.

(xii) Payments made from one country to another other than Sri Lanka (except account holder is resident in Sri Lanka), on instructions directly from clients outside Sri Lanka.

(xiii) Payments relating to participation in foreign seminars, conferences & delegations including registration fees.

(xiv) Any remittances made through Personnel Foreign Currency accounts(PFC)

To obtain the **Clearance Certificate** the remitter is required to submit an application attached to this circular to the **International Tax Unit** along with a copy of the invoice, a copy of the agreement and/or any other proof to enable the officers to verify the transaction relation to the outward remittance.

The Clearance Certificate will be issued within 24 hours by the International Tax Unit if the necessary documents are produced. The Remitter can apply for a Blanket Clearance where there is no income tax liability subject to the satisfaction of the Commissioner, International Unit. Such clearance will be issued covering certain period of time. At any given point, IRD officers may visit banks to scrutinize the accuracy of remitting money based on the clearances issued by the IRD.

If the customer needs any information, please request him to contact:

The Commissioner
International Tax Unit
10th Floor
Inland Revenue Department
Colombo 02
Telephone – 2135030

Yours faithfully,

Ivan Dissanayake
Commissioner General of Inland Revenue
Department of Inland Revenue
Sir Chittampalam A Gardiner Mawatha
Colombo 02

Ivan Dissanayake
Commissioner General of Inland Revenue

Copies to :

1. Secretary to the Ministry of Finance and Planning
2. Controller of Exchange, Department of Exchange Control
3. Director, Banks Supervision Branch
4. Secretary, Sri Lanka Banks' Association (Guarantee) Limited

} for circulation to all commercial banks and authorized dealers

5. Auditor General, Auditor General's Department

Attachment

Tax Clearance Application

Registration Number

1

Details of Remitter

Local Company Name - - .....

.....

Address - .....

.....

TIN - .....

Details of Remittee

Foreign Company Name - .....

.....

Country - .....

Tax File Number (If Available)

13/..... | 13/IND/..... | 13/P/.....

2

Details of Remittance

Nature of Remittance - .....

.....

Invoice Numbers - .....

Total Invoice Value	Remittance Amount	Currency

3

Tax Calculation **(Applicable for Tax Liable cases Only)**

- If **Net** Amount Remit

(Remittance Amount) X (Applicable Tax Rate) / 100

Currency | Tax Amount

- If **Gross** Amount Remit

(Remittance Amount) X (Applicable Tax Rate) / 100 - (Applicable Tax Rate)

Currency | Tax Amount

Applicable Exchange Rate & Date | Tax Paid Amount (LKR)

4

Remarks (If available) - .....

.....

❖ Please attach Copy of Invoices, Copy of Agreement (If Available) & Copy of paying-in-slip

Name – .....

.....

Authorized Signature

Designation & Contact Number – .....

For Office Use Only

Officer Name

Signature

Direction - .....

.....

.....

.....

.....

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තැ.පෙ. 515, කොළඹ 2- ශ්‍රී ලංකාව

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E-Mail – cgir@sltnet.lk
Web: www.ird.gov.lk

Circular No: **SEC/2018/06** 18.04.2018

Circular to Withholding Agents - Withholding of Tax from Payments Made under Section 84 and 85

This Circular sets out explanatory notes and guideline to facilitate **withholding agent**, on the application of the provisions of section 84 and 85 of the Inland Revenue Act, No. 24 of 2017 (the Act) with effect from April 1, 2018 and withdrawn Circular No: SEC/2018/05 issued on 29.03.2018 the above subject.

Part I – Deduction of Withholding Tax under Section 84.

1.1 To whom this Circular is Applicable.

1.1.1. WHT should be deducted from any payment or allocation which has a source in Sri Lanka and which is made by a person (WHT Agent) to any Resident or Non-Resident person;

i. where the payment being-
   a) dividend, interest, discount, charge, natural resource payment, rent, royalty, premium or retirement payment or
   b) amounts as winning from a lottery, reward, betting or gambling, and

ii. where the allocation being-
   a) any partner's relevant share of any partnership income of the partnership.

1.1.2. WHT should be deducted from any sale price payable to the seller of any gems sold at an auction conducted by the National Gem and Jewellery Authority.

1.2 Time of Deduction.

Tax should be deducted at the time the payment is made to any person, credited to a bank account on behalf of recipient or allocation of partner's relevant share of partnership income.

1.3 Non-Deduction of withholding Tax.

The tax deduction required under section 84 is not applicable to the following payments.

(a) payments subject to withholding under section 83 (employment income).

(b) payments made by individuals, unless made in conducting a business.

(c) Interest paid to any financial institution on the ordinary loans and advances provided by it.

(d) interest or discount paid to any person on Security or Treasury Bond or Treasury Bill.

(e) payments or allocations that are exempt amounts under section 9 of the Act; (The withholding agent is required to seek from the withholdee a certificate issued by the Commissioner General of Inland Revenue confirming that such withholdee is qualified for this exemption).

1.4 Rates of Deduction.

Every withholding agent should deduct income tax on the above referred payments as follows.

(a) payments mentioned in para 1.1.1 (i) –

(i) in the case of interest paid to a senior citizen - 5% on the amount exceeds Rs. 1,500,000/= .

(ii) in other cases where the interest or discount paid to a person - 5%;

(iii) in the case of rent paid to a resident person – 10%; and

(iv) in all other cases - 14%;*

(b) allocations mentioned in para 1.1.1 (ii) - 8%.

(c) payments mentioned in para 1.1.2 – 2.5%.

*When the payment is made to a Non-Resident person the tax rate specified in the relevant Double Taxation Avoidance Agreement should be applied, if the rate mentioned here is greater than the rate specified in the agreement. For such cases a confirmation should be obtained from the International Tax Branch of the Department of Inland Revenue.

Part II – Deduction of Withholding Tax under Section 85

2.1 To whom this Circular is Applicable.

2.1.1. WHT should be deducted from any service fee or any contract payment which has a source in Sri Lanka and which is made by a person (WHT agent) to **any Resident Individual** who is not an employee of the payer where the payment being

a) for teaching, lecturing, examining, invigilating or supervising an examination;

b) as a commission or brokerage to a resident insurance, sales or canvassing agent;

c) as an endorsement fee;

d) in relation to the supply of any article on a contract basis through tender or quotation;

e) for any service provided in the capacity of independent service providers such as doctors, engineers, accountants, lawyers, software developers, researchers, academics, or any other similar service; **

f) for any service of construction work, security service, janitorial service, consultation work of any kind, organizing of events, catering, designers, dress makers, tour guidance, entertainment, agency functions or any similar services or connected work where such services are provided under an agreement or otherwise; **

g) for any management service; **

h) for any type of vocational services provided as an independent service provider. **

** Gazette notification is due to be published by the Honorable Minister of Finance.

2.1.2. WHT should be deducted from payment of any service fee or insurance premium with a source in Sri Lanka which is made by a person to a Non-Resident person;

2.1.3. WHT should be deducted from payment made by a person to a Non-Resident person who conducts transport business as specified in sub section 73(1)(h) or telecommunication business as specified in subsection 73(1)(i).

2.2 Time of Deduction.

Tax should be deducted at the time the service fee or contract payment is paid to any person.

2.3 Non-Deduction of withholding Tax.

The tax deduction required under section 85 is not applicable to the following payments.

(a) payments subject to withholding under section 83 (employment income);

(b) payments made by individuals, unless made in conducting a business;

(c) payments that are exempt amounts; ***

(d) payments of service fee in respect of which ESC is payable by the withholdee.***

***The withholding agent is required to seek from the withholdee a certificate issued by the Commissioner General of Inland Revenue confirming that such withholdee is qualified for the exemption under para 2.3 (c) or 2.3 (d). Such certificate can be obtained from the Business Consultation Unit or any Regional Office by making a request.

2.4 Rates of Deduction.

Every withholding agent should deduct income tax on the above referred payments as follows:

(i) payments mentioned in para 2.1.1 – 5% on amounts exceeding Rs. 50,000 per month;

(ii) payments mentioned in para 2.1.2 – 14%; ****

(iii) payment to a non-resident person as mentioned in para 2.1.3 – 2%. **

****The tax rate specified in the relevant Double Taxation Avoidance Agreement should be applied, if the rate mentioned here is greater than the rate specified in the agreement. For such cases a confirmation should be obtained from the International Tax Branch of the Department of Inland Revenue.

Part III – Registration, Payment, Certificate of Deduction and Returns.

3.1 Registration.

All WHT agents are required to obtain a registration number from the Tax Type Registration Unit of Inland Revenue Department for the purpose of deducting the WHT from any withholdee. Any WHT agent who has not been assigned a Tax Payer Identification Number so far should get TIN Number first from the Primary Registration Unit or relevant Regional Office. Instructions regarding the registration is available in the web Portal of Department of Inland Revenue.

3.2 Calculation of WHT.

The withholding tax deduction should be made on the gross amount of the invoice value (inclusive of all taxes other than VAT).

3.3 Payment of tax withheld or treated as withheld.

Any tax that has been with held during each calendar month by the withholding agent, must be paid to the Commissioner-General (to the People's Bank Account No. 014-1002-6-9026620 by using the paying in slip issued by the IRD) within 15 days from the end the month. Any withholding agent who fails to withhold tax in accordance with this Division must nevertheless pay the tax that should have been withheld in the same manner and at the same time as tax that is withheld.

3.4 Certificate of Deduction.

The withholding agent who deducts withholding tax is required to issue a certificate of tax deduction to every withholdee in the relevant format specified in **Annexure 1(a) or 1(b) or 1(c)**. The withholding certificate shall cover a calendar month and be served within 30 days from the end of the month.

Where the certificate is computer generated, it should contain the phrase "This is a computer-generated certificate. Therefore, no signature is required"

3.5 Submission of Returns and Schedules.

(i) Returns –

Every withholding agent should file an annual statement specified by the Commissioner General of Inland Revenue, for each year of assessment within 30 days from the end of year (on or before 30th April) Return should be furnished by all registered withholding agents even in the instances where no any tax is payable.

(ii) Schedules –

Schedules prepared in the relevant formats as specified in the Annexure 2(a) or 2(b) or 2(c) for the payments on which WHT deducted, and Annexure 3 in respect of the payment on which WHT not deducted, should be furnished alone with the annual statement.

The schedules are required to be furnished in electronic form (Excel csv format). Templates of the above schedules are available in the web portal of the Department of Inland Revenue and instructions on furnishing the Returns & Schedules in electronic form will be provided time to time.

D.M.L.I. Dissanayake
Commissioner General of Inland Revenue

Cc: Auditor General
Secretary to the Treasury
Deputy Secretary to the Treasury

Annexure 1(a)

Certificate No:/ Serial No:

Withholding Agent's TIN:

Certificate of Tax Deduction – Service Fee

Name and address of the Withholding Agent: .....

Name and address of the Withholdee: .....

National Identity Card No. /Passport No. / Taxpayer Identification No of the Withholdee:

Period: from: ..... to: .....

(a) Nature of the payment (ex. Rent, Royalty, Service Fee etc.) .....
(b) Gross amount of the payment exclusive of VAT (Rs,): .....
(c) (i) Rate of tax: .....
(ii) Amount of tax deducted excluding VAT (Rs.): .....
(d) Date/s of tax deduction: .....
(e) Date of remittance: .....

.....

Name of the Authorized Officer

.....

Signature of the Authorized Officer

Date: .....

Annexure 1(b)

Certificate No:/ Serial No:

Withholding Agent's TIN:

Certificate of Tax Deduction - Interest

Name and address of the WHT Agent (Bank/Financial Institution): .....
.....

Name and address of the Depositor: .....

National Identity Card No. /Passport No. / Tax Identification No.: .....

Period: from: ..... to: .....

(a) Gross amount of the interest (Rs,): .....
(b) (i) Rate of tax: .....
(ii) Amount of tax deducted (Rs.): .....
(c) Date of tax deduction .....
(d) Date of Remittance: .....

.....
Name of the Authorized Officer

.....
Signature of the Authorized Officer

Date: .....

Annexure 1(c)

Certificate No:/ Serial No:

Withholding Agent's TIN:

Certificate of Tax Deduction - Dividends

Name and address of the WHT Agent: .....

Name and address of the Withholdee: .....

National Identity Card No. /Passport No. / Tax Identification No. Of Withholdee: .....

.....

		Gross Dividend	Withholding Tax	Net Dividend
Paid out of Dividend Received	Exempt			
	Liable			
	Total			
Paid out of Profit & Income	Exempt			
	Liable			
	Total			
Total				

Date of tax deduction: .....

Date of remittance: .....

.....

Name of the Authorized Officer

.....

Signature of the Authorized Officer

Date: .....

Annexure 2 (a)

Year of Assessment: .....

Name & TIN of the Withholding Agent: .....

WHT - Schedule 1 (WHT Deduction from interest / Discount)

Serial No	Type of investment	Name	Address	TIN / NIC/ Passport No/	Account No / Certificate No	Date of Commencement of Deposit/ Investment (YYYY-MM-DD)	Date of Maturity (YYYY-MM-DD)	Account Value / Investment Value (Rs)	Interest Rate (%)	Interest paid/ payable (Rs)	Rate of WHT (%)	WHT (Rs)	WHT Certificate No	Date of WHT remitted to IRD

.....

Signature of the Authorized Officer

Date: .....

Annexure 2(b)

Year of Assessment: .....

Name & TIN of the Withholding Agent: .....

WHT - Schedule 2 (Service Fee)

Serial No	Type of Payment	Name	Address	TIN / NIC/Passport No/	Receipt No	Date of Payment to Withholdee	Paid Amount (Rs)	Rate of WHT (%)	WHT (Rs)	WHT Certificate No	Date of WHT remitted to IRD

.....

Signature of the Authorized Officer

Date: .....

Annexure 2(c)

Year of Assessment: ……..

Name & TIN of the Withholding Agent:: ……

WHT - Schedule 3 (Gross Dividend Distributed)

Shareholder's TIN/ID No	Date of Distribution (YYYY-DD-MM)	Gross Amount Distributed	Exempt Amount	Liable Amount	Tax Rate	Dividend Tax Deducted	Dividend Tax Not Deducted	Date of Payment (YYYY-DD-MM)	Date of WHT remitted to IRD

……

Signature of the Authorized Officer

Date: ……

Annexure 3

Year of Assessment: .....

Name & TIN of the Withholding Agent: .....

WHT - Schedule 5 (Details of Withholding Tax not deducted)

Serial No	Type of payment	Name	Address	TIN / NIC/Passport No/	Date of Payment to Withholdee	Paid Amount (Rs)	Reason for exemption / not deducted
						Total	

.....

Signature of the Authorized Officer

Date: .....