

Types of Companies and Tax Rates

INTRODUCTION

This chapter introduces the **different entities** included under the definition of 'Companies' under the Inland Revenue Act No. 24 of 2017, **residential status** of a company and the applicable **tax rates** for different entities included in companies **under the Inland Revenue Act No. 24 of 2017**.

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1 Introduction and Imposition of Income Tax

In the process of studying tax law, the most important section to study is the **charging section** of the relevant Act and hence, we will first study the charging section (Section 2) of the Inland Revenue Act No. 24 of 2017.

As per Section 2 (1) of the Act, **Income Tax** shall be payable for **each year of assessment** **by:**

- (a) a **person** who **has taxable income** for that year or
- (b) a **person** who **receives a final withholding payment** during that year.

By reading Section 2(1) along with Sections 2(2), 2(3) and 2(4) of the Act, the income tax payable is equivalent to;

(a) (Taxable Income x Rate/s*) – tax credits, if any

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(b) Final withholding payment x Rate/s*

**The relevant tax rates are given in First Schedule to the Act.*

It is to be noted that;

- a **resident person** shall pay income tax (IT) on the world income, while
- a **non-resident** person shall pay IT on the income that arises in/from Sri Lanka. (Sec. 4)

1.1 Interpretations Relating to Charging Section

For better understanding of the tax law, it is important to know the interpretation of the important words included in the charging section of the Act.

- **Year of Assessment (Y/A)** means the period of 12 months commencing on the 1st day of April of any year and ending on the thirty first day of March in the immediately succeeding year. (Sec. 20)
- **Person** means an individual or an entity and includes a body of persons corporate or unincorporated, an executor, non-governmental organization and charitable institution. (Sec. 195)
- **Entity** means a company, partnership or trust, but excludes an individual. (Sec.195)

It is to be noted that a “Person” in the previous Act excluded partnerships, but under the new Act partnerships are included under the definition of “Person”.

- **Body** means a company, partnership, trust or other body of persons whether formed in SL or elsewhere.

- **Charitable Institution** means the trustee or trustees of a trust or corporation or an unincorporated body of persons established for a charitable purpose only or engaged solely in carrying out a charitable purpose. (Sec. 195).

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

(a) the relief of poverty;

(b) the advancement of education or knowledge other than by any institution established for business purposes or by any institution established under the Companies Act;

(c) activities for the protection of the environment or eco-friendly activities;

(d) the advancement of religion or the maintenance of religious rites and practices or the administration of a place of public worship;

(e) any other purpose beneficial to the community, not falling within any of the above categories. (Sec. 195).

- **Partnership** means 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. (Sec. 195).

- **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

(c) 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; (Sec. 195).

- **Trust** means an arrangement under which a trustee holds assets. (Sec. 195).

- **Non-governmental Organizations** are also defined in Section 195.

2 Definition of a Company

By studying the definitions given in the Inland Revenue Act No. 24 of 2017, it is clear that the companies recognized in the Inland Revenue Act is totally different from a company recognized in the Companies Act No. 7 of 2007, since the Inland Revenue Act gives a wider coverage. It includes even an unincorporated association and other body of persons such as friendly society, building society, pension fund, provident fund, retirement fund, superannuation fund, a government excluding the Sri Lankan government, a political sub-division of a government, or a public international organization, partnership where twenty or more of the partners have limited liability for the debts of the partnership and certain unit trust or mutual funds.

By studying the definition, a **person liable for income tax** includes;

- **Individuals** and
- **Entities;**
 - Companies (a corporation, unincorporated association or other body of persons),
 - Partnerships and
 - Trusts

As per the Inland Revenue Act a **company may be a legal** person or not. Hence, taxing of any entity excluding partnerships and trusts comes under companies.

A company (as defined above) is liable to income tax on its taxable income (gains and profits) of that year or on final withholding payment during the year (receiving of gain or income subjected to final withholding tax). It is on the gain and income accruing to that year. It is to be noted that there is no separate distinction in determining the gains and income of a company from any other entity.

3 Residential status of a company

A company is recognized as a separate entity from its owners. In determining the residential status of a company, the criterias to be considered are the location where it is formed, location of the registered or principal office of the company and the **location where effective control and management** of the company are exercised.

Resident Company

A company is deemed to be a resident if any one of the following criteria is satisfied:

- It is incorporated or formed under the laws of Sri Lanka,
- Its registered or principal office is in Sri Lanka, **or**
- At any time during the year the management and control of its affairs of the company are exercised in Sri Lanka.

[Section 69(4) of the Inland Revenue Act No. 24 of 2017]

A resident company is chargeable with income tax on profits and income wherever arising ***[Section 02 (1)(a) of the Inland Revenue Act No. 24 of 2017]***.

Non-Resident Company

A company is deemed to be a non-resident under the following circumstances:

- Its registered or principal office is outside Sri Lanka, **or**
- The control and management of its business are exercised outside Sri Lanka.

A non-resident company is chargeable with income tax on profits and income arising in or derived from Sri Lanka ***[Section 04 of the Inland Revenue Act No. 24 of 2017]***.

3.1 Registered or Principal Office

A company registered under the laws of Sri Lanka having its registered or principal office in Sri Lanka is deemed to be a resident company.

3.2 Control and management of business

In the case of foreign companies, the condition whether they are deemed resident in Sri Lanka or not depends on the place where the control and management of their business are exercised. Control and management are very significant in determining the residential status of a foreign company.

Control and management of the business of a company are not exercised by ordinary employees but by the highest decision-making body in the decision-making hierarchy of the company.

Accordingly, when the control and management of the business of a company are exercised in Sri Lanka, such company is deemed to be resident under the Inland Revenue Act even though its registered or principal office is situated outside Sri Lanka.

4. Different types of Companies

Although there are different types of companies under the Companies Act, such types are not important for the tax purposes under the Inland Revenue Act No. 24 of 2017. However, companies having **associates** are not eligible for some tax concessions.

Associates or associated persons are defined in Section 196 of the Act as follows;

(1) For the purposes of this Act, two persons are **associates or associated persons** where the relationship between the two is –

- (a) that of an individual and a **relative** of the individual;
- (b) that of partners in the same partnership;
- (c) that of an entity and a person referred to in Subsection (2); or
- (d) in any case not covered by paragraphs (a) to (c), such that one may reasonably be expected to act, other than as employee, in accordance with the directions, requests, suggestions or intentions of the other,

(2) A person and an entity are **associated persons** where –

- (a) the person controls the entity or may benefit from fifty percent or more of the rights to income, capital or voting power of the entity –
 - (i) either alone or together with persons who, under another application of this Section, are associated with the person; and
 - (ii) whether directly or through one or more interposed entities; or
- (b) the person, under another application of this Section, is an associate of a person referred to in paragraph (a).

(3) In this Section, “**relative**” in relation to an individual, means the individual’s child, spouse, parent, grandparent, grandchild, sibling, aunt, uncle, nephew, niece or first cousin, including by way of marriage or adoption.

5. Income tax rates of companies

5.1 Tax rates (First Schedule to the Inland Revenue Act)

The income tax rates applicable to companies could be categorized as follows;

1. On taxable income of a company;

- Concessionary rate of 14%
- Higher rate of 40%
- Standard rate of 28%

2. On capital gains of a company;

- Standard rate of 10%

3. On remittances of a company;

- By a non-resident companies 14%.

5.1 Concessionary tax rates – 14% (First Schedule to the Act)

Concessionary tax rates may be applicable to a company depending on the specific **business activity** of the company in a year of assessment or on **size of the business volume** of a year of assessment.

The **concessionary tax rate of 14%** is applicable in the following cases;

5.1.1 On Small and Medium Enterprises (SME) – 14%

As per Section 195 of the Act;

“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 persons annual gross turnover is less than Rs. 500,000,000/-;*

Any person who fulfils all the above three conditions (i.e. business in Sri Lanka, no associates and annual turnover less than Rs. 500 million) and is not engaged in the business of betting, gaming, liquor and tobacco is entitled for the concessionary tax rate of 14% without considering the nature of business.

5.1.2 Exports – 14%

A company predominantly (more than 80% of the gross income from exports) conducting a business of exporting goods (whether non-traditional or otherwise) and services are covered under this.

Further, the **specified undertakings** (as defined in Section 195) which includes the following businesses are also covered with this.

- entrepot trade
- offshore business
- front end services to clients in abroad
- headquarters operations of leading buyers
- logistic services such as bonded warehouse or multi-country consolidation in Sri Lanka
- transhipments
- freight forwarding
- supply of certain services to exporters
- production and manufacture and supply an exporter of non-traditional goods
- performing of some specified services
- local sale of gems and jewellery in foreign currency

5.1.3 Agricultural business – 14%

A company predominantly (more than 80% of the gross income from agriculture) conducting **agricultural business** is covered under this.

As per Section 195 of the Act;

“Agricultural business” means the business of producing agricultural, horticultural or any animal produce and includes an undertaking for the purpose of rearing livestock or poultry;

5.1.4 Education – 14%

A company predominantly (more than 80% of the gross income from education) conducting **educational services** is covered under this.

However, the term **“educational services”** is not defined in the Act and as a result without differentiation all types of educational services shall be covered under the law.

5.1.5 Promotion of Tourism – 14%

A company predominantly (more than 80% of the gross income from promoting of tourism) engaged in an undertaking for the **promotion of tourism** is covered under this.

As per the First Schedule to the Act;

“the promotion of tourism” means an undertaking for the operation of;

- (a) any hotel or guesthouse 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;

5.1.6 Information Technology (IT) Services - 14%

A company predominantly (more than 80% of the gross income from promoting of tourism) providing information technology services is covered under this.

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.

5.1 Higher tax rate - 40% (First Schedule to the Act)

A company with income from a business consisting of **betting and gambling, liquor and tobacco** (excluding such income which is merely incidental to another business) is covered under this.

5.2 Standard tax rate - 28%

All companies not covered in para 5.2 and 5.3 above are to be taxed at the standard rate of 28%.

5.3 Capital Gain tax - 10%

Capital gain is the income from realization of investment assets which shall be taxed to the company at the rate of 10%.

5.4 Remittance Tax - 14%

The rate of tax payable by a non-resident person who has remitted profits (under Section 62 of the Act) shall be taxed at the rate of 14%.



CHAPTER ROUNDUP

- ↳ Where the registered or principal office of the company is situated outside Sri Lanka or control and management of the company is exercised outside Sri Lanka such company is deemed to be a **non-resident company**.
- ↳ By using different statutes in Sri Lanka, companies can be classified as quoted public companies/non-quoted companies, resident/non-resident companies, off-shore and overseas companies, etc.
- ↳ The rate of income tax of a company is based on the taxable income of the company.

**PROGRESS TEST**

- 1 State whether the following companies are resident or not for the purposes of determining their income tax liability under the Inland Revenue Act.
 - (a) A BOI company in Sri Lanka which is fully owned by non-resident shareholders outside Sri Lanka.
 - (b) A company incorporated outside Sri Lanka has a branch office (overseas company) registered in Sri Lanka to carry out a project in Sri Lanka and the day to day business decisions are made by a project manager in Sri Lanka.
- 2 Calculate the gross income tax liability of the following companies (which are not members of a group of companies) by using the applicable tax rate for Y/A 2018/2019, if the taxable income of the companies are as follows;
 - (1) ABC (Pvt) Ltd, a company engaged in agriculture business - Rs. 4,250,000
 - (2) EFG (Pvt) Ltd, a company engaged in educational business - Rs. 5,000,000
 - (3) LMN (Pvt) Ltd, a Company engaged in liquor manufacturing - Rs. 5,400,000
 - (4) PQR PLC, a company engaged in export of tea in bulk where the annual turnover is Rs. 400 million - Rs. 6,111,111
 - (5) XYZ (Pvt) Ltd, a subsidiary of a quoted company where the annual turnover is Rs. 400 million - Rs. 6,900,000

- 1 (a) A company is considered as a resident company if;
- : it is incorporated or formed under the laws of Sri Lanka;
 - : it is registered or the principle office is in Sri Lanka; **or**
 - : at any time during the year the management and control of the affairs of the company are exercised in Sri Lanka.

The requirement to be a resident company is meeting any one of the above conditions. The said BOI Company fulfill not only one of the said conditions but it fulfills all three conditions. Therefore it is a resident company.

- (b) A branch office is acting on behalf of the principal company which is abroad and the policy decisions are made at the head office outside Sri Lanka. Accordingly, such company will be treated as a non-resident company for tax purposes.

2. (1) ABC (Pvt) Ltd - Rs. 4,250,000 x 14% =	Rs.	595,000
(2) EFG (Pvt) Ltd - Rs. 5,000,000 x 14% =	Rs.	700,000
(3) LMN (Pvt) Ltd - Rs. 5,400,000 x 40% =	Rs.	2,160,000
(4) PQR PLC - Rs. 6,000,000 x 14% =	Rs.	840,000
(5) XYZ (Pvt) Ltd – Rs. 6,900,000 x 28% =	Rs.	1,904,000