

# Taxable Income of a Company

## INTRODUCTION

This chapter explains the **adjustments** to be made when computing the **taxable income** of entities termed as companies for taxation, in accordance with the provisions of the Inland Revenue Act No. 24 of 2017.

## **CHAPTER CONTENTS**

- 1. Introduction - Total Assessable income of a company**
  - 1.1 Gains and Profit from Business**
    - 1.1.1 Computation of assessable income from business (Income, Outlays & Expenses, Disallowable, Special Restrictions on allowing expenses, claiming losses, tax on special business)
  - 1.2 Gains and Profit from Investment**
    - 1.2.1 Composition of Investment Income
    - 1.2.2 Inclusions in Investment Income
    - 1.2.3 Exclusions in Investment Income
    - 1.2.4 Capital Gains
- 1.3 Other Income**
- 2. Calculation of Taxable Income**
- 3. Calculation of Income Tax**
- 4. Calculation of balance tax (payable/overpaid)**
- 5. Tax on Shareholders (on dividends/distributions)**
  - 5.1 Tax on dividends distributed
  - 5.2 Definition of Dividend
  - 5.3 Tax on Gains on disposal of shares in a company
- 6. Tax on Remittances**
- 7. Asset transfers between entities and members**
- 8. Limitations as a result of change in ownership of an entity**

# 1 Total Assessable Income of a Company



## Introduction

The total assessable income of any person (including a company) for any year of assessment shall be the aggregate of the **assessable income** for that year of assessment from every source of the income listed below;

- **Employment**
- **Business (detailed in paragraph 1.1 in this chapter)**
- **Investment (detailed in paragraph 1.2 in this chapter)**
- **Other**

*[Section 4 of the Inland Revenue Act]*

However, employment income is not applicable to a company and hence we will discuss the other three sources of assessable income in this chapter.

As stated in Chapter 1 of this text **a Company means;**

*(a) 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).*

Accordingly, this chapter covers the taxation of all types of companies which includes corporations, unincorporated associations & bodies, societies, organizations, funds and governments.

## 1.1 Gains and Profits from Business

A person's income from a business for a year of assessment shall be the person's **gain and profits** from conducting the business for the year (Section 6 of the Act). A company being a person for taxation, this statement is equally applicable to a company as well. Hence, a company's assessable income from business (**gain and profits** from conducting a business) is to be computed in a similar way to the calculation of profit from business of any other entity.

### Business:

#### (a) Includes-

- (i) *A 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;

*[Section 195 of the Inland Revenue Act]*

It is to be noted that the income from business is liable to tax, however short the duration, if it has the business character.

### 1.1.1 Computation of assessable income from business

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 from the gross income. However, no deduction shall be allowed for an expense of a capital nature. The expense of a capital nature includes an expense that secures a benefit capable of lasting longer than twelve months.

**(Section 11 of the Act)**

#### 1.1.1.1 Income;

In calculating a person's gain or income from conducting a business for a year of assessment, the following amounts derived by that person during the year of assessment from the business **shall be included**.

- (a) Service fee;
- (b) Consideration received in receipt of trading stocks;
- (c) Gains from the realisation of capital assets and liabilities of the business as calculated under Chapter IV of the Act; (gain on non-investment assets/liabilities)
- (d) Amounts required to be included by the Second or Fourth Schedule to the Act on realisation of the person's depreciable asset assets of the business;
- (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;
- (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; and
- (h) Other amounts required to be included under this Act.

In calculating a person's gain or income from conducting a business for a year of assessment the following amounts derived by that person during the year of assessment from the business **shall be excluded**.

- (a) Exempts amounts and income subjected to final withholding tax; and
- (b) Amounts that are included in calculating the person's income from an employment.

**(Section 6 of the Act)**

#### **1.1.1.2 Expenses;**

Entities prepare their financial statements in accordance with Sri Lanka Financial Reporting Standards (SLFRS). Therefore, it is essential to adjust the book or accounting profits to fit in to the provisions of the Inland Revenue Act to arrive at the assessable income for tax purposes. Accordingly, certain expenses recorded under accounting principles would not be allowed for tax purposes, whereas certain specific deductions provided in the Inland Revenue Act need to be incorporated into the computation.

Adjustments required to convert accounting profits into tax profits are as follows;

##### **1.1.1.2.1 Disallowable Expenses;**

The following **deductions shall not be made** in calculating a person's income;

- (1) Domestic expenses incurred by the person (As described in Section 197);
- (2) Tax payable under this Act;
- (3) Interest, penalties and fines payable to the government or a political subdivision of a government of any country for breach of any written law;
- (4) Expenditure to the extent incurred by a person in deriving exempt amounts or income subjected to final withholding tax;
- (5) Retirement contributions, unless they are included in calculating the income of an employee **or** consist of a contribution by an employer to a pension, provident or savings fund or a savings society, approved by CG;
- (6) Dividend of a company;
- (7) Outlays or expenses for entertainment;
- (8) Reserves or provisions for expenditure or losses not yet incurred but expected to be incurred in a future year of assessment;
- (9) Amounts incurred on lotteries, betting or gambling, other than amounts incurred from conducting a business of lotteries, betting or gambling; or
- (10) Taxes or other levies specified by the CG.
- (11) The expenditure which is required to withhold tax shall not be allowed until the tax withheld has been paid to the CG.

No expenditure shall be allowed except as expressly permitted by this Act. Where more than one deduction applies, **the most specific deduction shall be applied**, even if that results in the denial of a deduction.

**(Section 10 of the Act)**

### 1.1.1.2.2 Special Restrictions on allowing expenses;

- **Interest on borrowed money** incurred in the production of income from the business or investment is allowed to the extent that the debt is utilized during the year or was used to acquire an asset that is used during the year in production of income. (Sec. 12)
- **Interest on any other debt obligation** incurred in the production of income from the business or investment is allowed to the extent that it was incurred in the production of income. (Sec.12)
- The **cost of sales** (value of trading stocks brought forward at the beginning of the year + expenses incurred during the year on trading stocks – value of trading stocks at the end of the year) is allowed as an allowable deduction. Accordingly, any **loss** due to the drop of market value of closing stock beyond the cost and the loss on reduction of quantity of stocks are also allowed. (Sec. 13)
- **Repairs & Improvements on depreciable assets**, incurred in the production of income from the business or investment, whether of a capital or revenue nature are deductible subject to following limits; (Sec. 14)
  - on depreciable buildings up to 5% of the brought forward WDV of the asset.
  - on other depreciable assets up to 20% of the brought forward WDV of the asset.
 The unclaimed amount, if any, due to the application of the above limitation, shall be added to the asset's depreciation base.
- **Research and development (R&D) expenses and agricultural start-up expenses** incurred during the year by the person and in the production of income, whether capital/revenue nature (research and development expenses related to upgrading the business or innovation/research related to high value agro products) is allowed in full (100%). (Sec. 15)
- **Capital allowances on depreciable assets** owned and used by a person at the end of the year in the production of person's income from a business shall be allowed, without the facility of deferment of claim (Sec. 16 read along with Fourth Schedule). The claimable capital (Depreciation) allowance cannot be differed. Further, the **balancing allowances (loss on disposal)** is also allowable as a deduction (as per Second or Fourth Schedule).

However, if there is an **assessable charge (profit/gain)** on disposal of a depreciable asset, it is to be included in to the adjusted profit for taxation as a business gain. (Sec. 16 read along with Second or Fourth Schedule)

Capital allowance rates on depreciable assets as per Fourth Schedule is as follows;

- Buildings, structures and similar works of a permanent nature - 5%
- Motor Vehicles & Furniture - 20%
- Computers, data handling equipment together with peripheral devices - 20%
- Plant, Machinery & Equipment - 20%
- Intangible Assets excluding goodwill – Within the actual useful life (If indefinite life @ 5%)

As per Section 195 of the Act “**depreciable asset**” means;

- (a) 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) Exclude goodwill, an interest in hand, a membership interest in an entity and trading stocks;

As per paragraph (4) of the Fourth Schedule of the Act no capital allowance shall be granted 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.

Paragraph (5) of the Fourth Schedule of the Act defines “commercial vehicle” as follows;

“**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.

\*However, the correct English translation of the word “ගමනාගමනය” given in the Sinhala text is **travelling** while as per Section 200 of the Act, in the event of any inconsistency, the Sinhala text shall prevail and as a result, until the Sinhala text of the Act is amended to rectify this error, all travelling vehicles are covered with the term “commercial vehicle” and hence all traveling vehicles are eligible for capital allowance for taxation.

### Balancing allowances and assessable Charges

If the assets on which the depreciation allowance has been granted are disposed of, certain adjustments are due under the provisions of the Inland Revenue Act.

The gain or loss on disposal of a depreciable asset is as follows;

Consideration received	xxx
Less; Tax written down value of the asset at disposal	(xx)
Assessable Charge ( <b>Gain</b> ) / Balancing Allowance ( <b>Loss</b> )	<b>xxx</b>

[Section 16 along with Forth Schedule]

Any gain or loss on disposal of a capital asset for which tax depreciation is not granted (e.g. land), is considered as a capital gain or a capital loss which is not considered in the computation of profit from business.

**Example 1: Disposal of a capital asset;**

A lorry purchased for Rs. 2,000,000/= in the year of assessment 2013/2014 was sold in the year of assessment 2018/2019 for Rs.1,200,000.

	<i>Rs.</i>
Cost (2013/2014)	2,000,000
Less: Capital Allowance for depreciation allowed	
2013/2014 – 20%	(400,000)
2014/2015 – 20%	(400,000)
2015/2016 – 20%	(400,000)
2016/2017 – 20%	(400,000)
2017/2018 – 20%	(400,000)
Tax written down value as at disposal	Nil
Selling price	1,200,000
Less: Tax written down value	(0)
Profit on disposal	1,200,000

The above lorry being a depreciable asset the disposal profit is a business income which is to be included in the business income and tax at the appropriate tax rate.

- **Financial Costs** are allowed subject to an **upper limit** with carry forward facility of unclaimed balance. (Sec. 18)

**The upper limit,**

- On a manufacturing entity - 3 times of the shareholders' equity\*,
- On a non-manufacturing entity - 4 times of the shareholders' equity\*.

*\*However, the **date** as at which the equity is considered (beginning date or end date of the year) is missing in the Act. Further, the rationale of fixing lesser weightage on manufacturing against non-manufacturing is not clear.*

- Payments made under a **Financial Lease purchase (lease rental)** or in acquiring an asset under an **instalment sale** shall be treated as a normal business loan and claim the interest as an allowable expenditure while claiming the allowable depreciation on the fair value of the leased/hire payment asset. Accordingly, the **annuity payments** shall be treated as interest and repayment of capital under a loan. (Sec. 31)  
Further, if it is a depreciable asset, allow the capital allowances thereon.
- The following expenses which were disallowed (in full or partly) under the former Act are **fully allowed under the New Act**;
  - Business advertising
  - Management fee
  - Business related foreign travel expenses



### 1.1.1.2.3 Treatment/Limitation of Claiming of Losses;

- **In calculation of the income of a person from business for a year of assessment, the following shall be deducted;**

- (a) an **unrelieved loss** from a business of the person for the year from any other business,
- (b) an **unrelieved loss** from a business of the person for any of the previous six years of assessment from the business or any other business. [Sec. 19(1)]

As a result, any business loss incurred during a year could be set off against any business income of that year or immediate next six years (altogether seven years) as the person wishes. However, a deductible loss shall be deducted without any other alternate action.

- **Business losses** could be deducted up to 100% of **business income plus investment income** and not from total assessable income (AI). Deductible losses shall be deducted.

*As per Section 19(6) of the Act, the “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.*

*As per Section 19(6) of the Act, the “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.*

- **Losses on realisation of business assets and liabilities** are deductible only up to the extent that asset or the debt obligation of the liability was for purchase of an asset in the production of income from the business and in other case the liability was incurred in the production of income of the business. (Sec. 17)

#### **Other Limitations of claiming losses:**

- **Investment losses** could be set off only against investment income. [Sec 19 (4)]
- As stated above, balance unrelieved loss, if any, could be carried forward for immediate next 6 years for claiming. [Sec 19 (1)]
- **Losses from long term contracts** could be carried back to set off against the previous years’ profits there on where the CG may allow the same. [Sec 25 (4) & (5)]
- Business or investment **Losses on incomes taxed at low rates** could be set off against any business or investment income as applicable that are not taxed at a higher rate. [Sec 19 (3)]
- Business or investment **losses on exempt source** could be set off only against exempt amounts as applicable. [Sec 19 (3)]
- **Banking business (banking business of a financial institution)** shall be treated as a separate business and the income/loss thereon shall be calculated separately. [Section 66(1)]

- The **finance lease and/or insurance business losses** could be set off against any business income subject to above limitations.
- **Loss on financial instruments** - As specified by CG such losses shall be set off against gain on Financial Instruments. (Section 18 of the Act read along with Gazette No. 2064/55). It should be noted that this Section of the law is not applicable for a financial institution.

#### 1.1.1.4 Tax on Special Businesses

- In **finance leasing** businesses the interest income on leases is taxable in the hands of lessor while there is no allowable depreciation on the leased assets. (Sec. 49)
- In **long term contract** business, income should be recognised on stage of completion method (percentage of the contract completed). (Sec. 25)
- In **life insurance** business the taxable income is the summation of surplus distributed to shareholders from policy holders fund and investment income out of the policy holders fund less expenses incurred in producing income. (Sec.67)
- In **Unit Trust** business; (Sec.59)
  - (i) Trusts engaged in eligible investments are treated as a trust & not as a company which is taxable @ 24%.
  - (ii) Trusts not engaged in eligible investments be treated as a company & not as a trust liable for income tax @ 28%.
- ***Engaged in eligible investments means a business predominately (minimum 80%) owning, investing or trading in capital assets, financial instruments or other similar assets.*** (Sec.195)

## 1.2 Investment Income Including Capital Gains

A person's **income from an investment** for a Y/A shall be the person's **gains and profits** from that investment for the year. [Section 7(1)].

### 1.2.1 Composition of Gains and profits from investment

The gain and profit from investments is comprised of the following;

- Periodical return** (Eg. Interest, dividends, discounts etc.) generated on that investment, plus
- The profit **on disposal** of the investment (capital gains on realization).

### 1.2.2 Inclusions In calculating gains and profits [Section 7(2)].

In calculating gains and profits from investment, **following shall be included;**

- Dividends, interest, discounts, charges, annuities, natural resource payments, rents, premiums & royalties,

- Gains from the realisation of investment assets as calculated under Chapter IV,
- Amounts derived as consideration for accepting a restriction on the capacity to conduct the investment,
- Gifts received by the person in respect of the investment,
- Winning from lotteries, betting or gambling and
- Other amounts required to be included under this Act.

### 1.2.3 Exclusions in calculating gains and profits [Section 7(3)].

In calculating gains and profits from investment, **following shall be excluded;**

- Exempted gains and profits,
- Gains and profits which have been subject to final withholding tax and
- Amounts included in employment or business profits and income.

### 1.2.4 Capital Gains (Sec. 36 to 51)

Gains from the realisation of **investment assets** shall be a **gain and profit** (commonly call as **Capital Gain**) from that investment under Sec. 7.

- **Capital Gain/(Loss) = Consideration received - Cost of the asset** (Sec.36).
- **Cost of an investment asset is equivalent to (Sec. 37);**
  - (a) the cost of acquisition, construction, manufacture or production of the asset,
  - (b) The cost of altering, improving, maintaining or repairing the asset,
  - (c) Incidental expenses incurred by that person in acquiring and realising the asset,
  - (d) Income amounts on;
    - (i) An amount required to be included in AI /any exempt /final WH amount in relation to the asset,
    - (ii) Expenses incurred by another person under (b) & (c) above on behalf of the person acquiring.

#### **Remarks:**

*After considering (b) and (c) above, it is implied that **when we prepare the adjusted profit for taxation of an entity from business**, the cost of altering, improving, maintaining or repairing of investment assets and the incidental expenses incurred there on shall not be charged against the income from the business and instead shall be capitalised with the investment asset/s. Further, those expenses being not expenses incurred in production of business income, shall not be allowed in arriving at the income which is to be taxed under business income. Even for financial accounting we may have to apply this accounting treatment.*

- Cost of an investment asset held by a person as at 30.09.2017 is equivalent to the Market Value of it as at 30.09.2017 (Sec.203).

- **Realisation of an asset means (Sec. 39);**
  - (a) Sold, exchanged, transferred, distributed, cancelled, redeemed, destroyed, lost, expired, expropriated or surrendered;
  - (b) When the person ceases to exist, including by reason of the death of an individual, immediately before the person ceases to exist;
  - (c) Consideration received from owning the asset (not being a trading stock or depreciable asset) exceeds the cost of the asset;
  - (d) A debt claim becomes bad even after reasonable steps of recovery;
  - (e) In the case of a trading stock, a depreciable asset, a capital asset of a business or an investment asset ceases to be an asset of any of those types; and
  - (f) Change of residency of a person as referred to in Section 70 of the Act.
- **Consideration Received for an asset means; (Sec. 38)**  
 Consideration received for an asset of a person at a particular time shall be;
  - (a) Amount received/receivable for the asset, including the fair value of any consideration in kind,
  - (b) Amounts derived from altering or decreasing the value of the asset and amounts derived from the asset including by way of covenant to repair or otherwise; and
  - (c) Amount derived or an entitlement to derive in future in respect of the asset.
- **Rate** of capital gain tax is 10%. (First schedule to the Act)
- **Payment of tax & Filing of Return** is within one month of the realization of the asset. [Section 82(2)(c)(i) & 93(3)]
- **Investment Asset means; (Sec. 195)**
  - (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 3 years before disposal and lived in for at least 2 of those 3 years (calculated on daily basis).
- **Capital Assets means; (Sec. 195)**
  - (a) 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) An option, right or other interest in an asset referred to in the foregoing paragraphs, but
  - (b) Excludes **trading stock\*** or a **depreciable asset\***.

\*these terms are interpreted in Section 195 of the Act.
- **Tax Exempted Capital Gains** [Third Schedule to the Act]
  - (a) Gain on realisation of a resident individual's principal place of residence, if it is owned continually for 3 years immediately before disposal and lived in by the individual minimum of 2 years during those 3 years.

- (b) Gains received by a resident individual on realisation of investment asset that does not exceed Rs. 50,000 (per asset) and where the total gains made from realisation of investment assets in the year of assessment does not exceed Rs. 600,000.
- (c) Gains on shares quoted in any official list published by any stock exchange licensed by the Securities and Exchange Commission (SEC) Sri Lanka.

- **Provisions to exclude some transfers from Capital Gains tax**

- (a) Transfer to a spouse/ex-spouse by an individual - The amount derived by realisation should be treated as equivalent to the net cost. The recipient of the asset to treat the said amount as the expenditure incurred by that individual. (Section 44)
- (b) Transfer on death of an individual - The amount derived by realisation of asset as a result of death is equivalent to the net cost. The recipient of the asset to treat the said amount as the expenditure incurred by that person. (Section 45)
- (c) Transfer to an associate/gift to a charitable institution by a person - Treat the amount derived by realisation as equivalent to the higher of the market value of the asset or the net cost of the asset at the time of realisation. The recipient of the asset to treat the said amount as the expenditure incurred by that person. (Section 46)
- (d) Transfer to an associate/to a charitable institution by an individual - Treat the amount derived by realisation as equivalent to the net cost of the asset at the time of realisation. The recipient of the asset to treat the said amount as the expenditure incurred by that person. [Section 46 (2)]. The **associate** in relation to an individual is defined in Section 46(3) (a few listed close relations).
- (e) Transfer of assets of a business (trading assets/depreciable asset/investment asset/capital asset of a business) of a **resident person** to a **resident associate** who is not a tax exempted person or a partnership where none of the partners are tax exempted - Treat the net cost at the time of realisation as equivalent to the amount derived. The associate (recipient of the asset) to treat the said amount as the expenditure incurred. [Section 46 (4)].
- (f) Transfer of assets involuntarily by a person and replace - In such a case treat the net cost of the asset/s as at that date plus the amount under invested out of the amount realised to acquire the replacement asset/s, if any, as equivalent to the amount realised. (Section 47)

### 1.3 Other Income (Section 8)

A person's income from other sources for a year of assessment shall be that person's gains and profits from any source whatsoever for the year, not including profits of a casual and non-recurring nature.

However, in calculating a person's gains or profits from any source, the following shall be excluded;

- (a) Exempt amounts and amounts where the final WHT is deducted,
- (b) Amounts that are included in calculating the person's income from employment, business or investment

## 2. Calculation of Taxable Income

### 2.1 Introduction of Taxable Income

The **taxable income** of a person for a year of assessment shall be equal to the total of that person's assessable income (i.e. employment income + business income + investment income + other income) for the year less qualifying payments and reliefs for that year under Section 52.

(Section 3)

The assessable income from each source shall be determined separately.

Each person should be treated as a separate taxable person and hence the taxable income of each person shall be determined separately.

The income tax computation involves the following steps;

- Assessable Income (total income from all four sources)
- Taxable Income
- Gross Income Tax

**The taxable income is computed as follows;**

Employment Income	xxx
Business Income	xxx
Investment Income	xxx
Other Income	<u>xxx</u>
<b>Total Assessable Income</b>	<b>xxx</b>
Less; Deductions under Sec.52	<u>(xx)</u>
<b>Taxable Income</b>	<b><u>xxx</u></b>

However, as we learnt above, certain deductions including losses are restricted to specific income source and as a result to meet the provisions of the Act, the **tax computation format** could be presented as follows;

Assessable Income from Each Source;	Employment*	Business	Investment	Others	Total
<b>Income</b>	<b>XX</b>	<b>XX</b>	<b>XX</b>	<b>XX</b>	<b>XX</b>
<b>Less;</b>					
Exempt Income (Third Schedule)	(xx)	(xx)	(xx)	(xx)	(x)
Final WHT Paid	(xx)	(xx)	(xx)	(xx)	(x)
Specific Exclusions	(xx)	(xx)	(xx)	-	(x)
Specially Allowable Amounts		(xx)	(xx)	-	(x)
Allowable Losses		(xx)	(xx)	-	(x)
<b>Add;</b>					
General Disallowable Amounts	-	xx	xx	-	xx
<b>Assessable Income</b>	<b>xx</b>	<b>xx</b>	<b>xx</b>	<b>xx</b>	<b>xx</b>
<b>Less; (Under Sec. 52 read along with Fifth Schedule)</b>					
Qualifying Payments					
Reliefs;					
Personal Allowance Individuals Rs.500,000 ( <i>For resident individuals &amp; SL Citizens</i> )*					( )
Employment Allowance < Rs.700,000 against Employment Income ( <i>For resident individuals Only</i> )					(x)
Qualified Donations					(x)
25% Repair Allowance on Rent ( <i>For individuals only</i> )*					(x)
S/Citizens Interest allowance < Rs.1.5million ( <i>For Citizens only</i> )*					(x)
F/Currency Service Income < Rs.15million ( <i>For resident individuals &amp; partners only</i> )*					(x)
<b>Taxable Income</b>					<b>xx</b>
<b>Income Tax</b> (At Relevant Rate/s as per First Schedule to the Act)					<b>xx</b>
<b>Less; Tax Credits</b>					
Foreign					(x)
Local					(x)
<b>Balance Tax Payable/(Overpaid)</b>					<b>xx</b>

\* Items marked with\* are applicable only to individuals.

## 2.2 Sec. 52 Deductions (Qualifying payments & Reliefs)

In arriving at the taxable income from assessable income, under Section 52 of the Act, there are two types of deductions from total assessable income as detail below.

- (a) **Qualifying payments** - As given in item (1) (a), (b) & (c) of Fifth Schedule.
- (b) **Relief** - As given in item (2) of Fifth Schedule

### 2.2.1 Qualifying Payments

The qualifying payments referred to in Section 52 and given in Fifth Schedule to the Act are 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 –
  - (a) in the case of an individual, one-third of the taxable income of the individual or Rupees seventy-five thousand, whichever is less;
  - (b) 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 of Sri Lanka or any Higher Educational Institution established by or under the Buddhist and Pali University of Sri Lanka 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.



### 2.2.2 Reliefs

The reliefs referred to in Section 52 and given in Fifth Schedule are as follows:

**(a) Personal Allowance –**

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 realisation of investment assets;

**(b) Employment Allowance –**

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; *(Accordingly, the actual employment income subject to a maximum of Rs. 700,000 can be claimed).*

**(c) Rental Allowance –**

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; *(Accordingly, the tax payee can select either the claiming of actual expenses or the 25% allowance)*

**(d) Senior citizens Interest Allowance –**

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; *(Accordingly, the actual interest income subject to a maximum of Rs. 1,500,000 can be claimed).*

**(e) Resident Individuals foreign currency income allowance –**

In the case of a resident individual or partner of a partnership with income earned in foreign currency in Sri Lanka, from any service rendered in or outside Sri Lanka to any person to be utilized outside Sri Lanka, Rs. 15,000,000 for each year of assessment, up to the total of such income for the year. *(Accordingly, the actual income subject to a maximum of Rs. 15,000,000 can be claimed).*

### 3. Income Tax Computation

Once the taxable income is arrived at, the applicable tax rates to be applied on related taxable income and compute the gross income tax.

#### 3.1 The income tax rates applicable to companies as given in the First Schedule to the Act are as follows;

- (1) Subject to subparagraphs (2) and (3), the taxable income of a company for a year of assessment shall be taxed at the rate of 28%.
- (2) The taxable income of a company for a year of assessment shall be taxed at the following rates:-
  - (a) **Small and Medium Enterprises** 14%
  - (b) A company predominantly conducting a business of **exporting** goods & services 14%
  - (c) A company predominantly conducting an **agricultural business** – 14%
  - (d) A company with income from a business consisting of **betting and gaming, liquor and tobacco** (excluding such income which is merely incidental to another business) 40%
  - (e) A company predominantly providing **educational** services – 14%
  - (f) A company predominantly engaged in an undertaking for the **promotion of tourism** 14%;  
and
  - (g) A company predominantly providing **information technology services**- 14%
- (3) Where a company's taxable income includes **gains from the realisation of investment assets (capital gains)**, 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). **(i.e. 14%, 28% or 40% as applicable)**

### 3.2 Important Interpretations

#### 3.2.1 As given in the First Schedule to the Act;

- (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.

### 3.2.2 As defined in Section 195 of the Act;

- (i) **“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;
- (ii) **“export”** is defined to say as; “export” includes **specified undertaking**;
- (iii) **“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) transshipment 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; and
- (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;
- (iv) **“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;
- (v) However, the word **“education”** is not defined in the Act.

#### 4. Balance Income Tax Payable

Once the gross income tax amount is computed the tax credits to be allowed to arrive the balance tax payable or overpayment.

The tax credits could be categorized in to two as follows;

- (a)** Foreign tax credits
- (b)** Local tax credits.



### Example 2: Computation of tax on taxable income

The taxable income of the three companies in the Favourite Group of Companies for the year of assessment 2018/19 are given below. All the companies are engaged in soft toys manufacturing activities for local market and the turnover of all three companies remained below Rs.500 Mn, for the year.”

	Rs.
Favourite Holdings Ltd – parent company	9,000,000
Favourite Cosmetics Manufactures Ltd – subsidiary company	6,000,000
Favourite Cosmetics Distributors Ltd – Associate company	3,000,000

**Calculate** the taxable income of and the tax payable by each company for the year of assessment 2018/19.

**Solution:**

Company	Taxable income Rs.	Tax rate	Amount of tax Rs.
Favourite Holdings Ltd	9,000,000	28%	2,520,000
Favourite Cosmetics Manufactures Ltd	6,000,000	28%	1,680,000
Favourite Cosmetics Distributors Ltd	3,000,000	28%	840,000

Each company has associate companies and as a result the concessionary tax rate of 14% under SME cannot be enjoyed by any of these companies. However, if any of these companies is engaged in export business where the export turnover is more than 80% of its total turnover [predominantly conducting business of exporting goods covered under para 4(2) of the First Schedule to the Act] that particular company can enjoy 14% concessionary rate on the entire taxable profit.



### Example 3: Computation of tax on taxable income

International School (Pvt) Ltd is an international school which operates in Colombo. The taxable income of the company for the year of assessment 2018/19 was Rs. 18,000,000 including Rs. 2,000,000 in interest from Treasury Bills.

**Calculate** the tax payable on taxable income.

**Solution:** Tax payable for the year:

	Rs.
On taxable income	Rs. 18,000,000 X 14%*
<b>Total tax</b>	<b>2,520,000</b>

**Solution:** \*As it is predominantly engaged in providing of educational services, the entire taxable income inclusive of interest is liable for tax at 14%.

**Example 4: Computation of tax on taxable income**

Durga International (Pvt) Ltd is engaged in the business of manufacturing and sale of latex products in the local and foreign markets. Taxable income and turnover of the company for the year of assessment 2018/19 was Rs. 39,000,000 and Rs. 390,000,000 respectively. The company has exported Rs. 130,000,000 worth manufactured products during the year.

**Calculate** income tax payable on taxable income of Durga International (Pvt) Ltd for the Y/A 2018/19 under following circumstances.

- (a) If Durga International (Pvt) Ltd is a isolated company
- (b) If Durga International (Pvt) Ltd is a subsidiary company of Durga Holdings Ltd

**Solution:**

(a) Tax payable for the year, if Durga International (Pvt) Ltd is an isolated company:

	Rs.
On entire taxable income of Rs. 39,000,000 X 14% (Since the turnover is less than Rs. 500,000,000 can apply SME rate)	5,460,000
<b>Total tax payable</b>	<b>5,460,000</b>

(b) Tax payable for the year, if Durga International (Pvt) Ltd is a subsidiary company of Durga Holdings Ltd.

	Rs.
On entire taxable income of Rs. 39,000,000 X 28% (Since it has an associate cannot apply SME rate)	10,920,000
<b>Total tax payable</b>	<b>10,920,000</b>

**Example 5: Computation of tax on taxable income**

Soft Liquor (Pvt) Ltd is engaged in the business of manufacturing and sale of liquor products mainly in the local market. Taxable income and turnover of the company for the year of assessment 2018/19 was Rs. 120,000,000 and Rs. 540,000,000 respectively.

**Calculate** income tax payable on taxable income of Soft Liquor (Pvt) Ltd for the Y/A 2018/19 under following circumstances:

- (a) If Soft Liquor (Pvt) Ltd is an isolated company
- (b) If Soft Liquor (Pvt) Ltd is a subsidiary company of Soft Liquor Holdings Ltd

**Solution:**

**(a) If Soft Liquor (Pvt) Ltd does not have associates,**

Tax on taxable income on liquor (115,000,000X40%)	Rs. 46,000,000
Tax on Interest Income (5,000,000X28%)	Rs. 1,400,000

Total Income Tax = **Rs. 47,400,000**

(The business of manufacturing liquor products cannot enjoy the SME tax rate).

**(b) If Soft Liquor (Pvt) Ltd is having an associate,**

The total tax payable is same as above.

## 5 Tax on Shareholders (on dividends/distributions)

### 5.1 Tax on dividends distributed (Section 61)

Where any resident company distribute dividends to its shareholders, it is to be taxed on the shareholders.

Where a non-resident company distribute dividends to its shareholders, it shall be included in calculating the income of the shareholders.

Dividends paid by a company is liable to dividend tax (WHT) at the rate of 14% under Section 84 of the Act read along with the First Schedule to the Act.

### 5.2 Definition of Dividend

**“dividend”**– (Section 195 of the Act)

(a) *means 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 capitalisation 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.*

As per the above definition the returning of capital is not considered as a dividend since it is merely a repayment of shareholders' own capital. However, as per this Act the capitalization of profits is treated as dividends.

### **5.3 Tax on Gains on disposal of shares in a company (Section 61)**

Gains on disposal of shares in a company shall be included in calculating the income of the shareholder.

## **6. Tax on Remittances (Section 62)**

A non-resident person carrying on business in Sri Lanka through a Sri Lankan permanent establishment shall pay a final tax computed at 14% (as per First Schedule) to the CG on the gross amount of remitted profits. Such tax shall be paid within 30 days of such remittance.

The "remitted profits" means amount remitted or retained abroad out of the profits and income of the non-resident person that are subject to income tax in Sri Lanka, and any amount received outside Sri Lanka by or on behalf of the non-resident person from conducting business in Sri Lanka that is subject to income tax in Sri Lanka, excluding dividends paid by a resident company to a non-resident person. (Sec. 62)

## **7. Asset transfers in between entities and members (Sec. 63)**

When the assets are transferred in between entities and its members, the value of realisation be treated as equivalent to the market value of the assets as at that time. The said value shall be treated as the amount realised to the transferor and the cost to the transferee.

## **8. Limitations as a result of change in ownership of an entity (Sec. 64)**

When the ownership of an entity changes by more than 50% as compared with the ownership at any time during the previous three years, the said entity is restricted from:

- (a) deducting the brought forward unclaimed financial costs from a period prior to the change of ownership, [Referred to in Sec. 18 (3)]
- (b) deducting an unclaimed loss brought forward from a period prior to the change, [Referred to in Sec. 19 (1)]
- (c) allowing the bad debts on an income recognised prior to the change of ownership. [Referred to in Sec. 24 (2), (4) or (5)]
- (d) carrying back a loss that was incurred after the change of ownership to a period prior to the ownership change. [Referred to in Sec. 25 (5)]

However, the above restrictions shall not apply to a partnership or company that conducts the same business after two years of the change.




**Example 6: Computation of gross tax liability and the balance tax payable**

ABC (Pvt) Ltd is in the business of manufacturing toys. The income statement of the company for the year 2018/19 is as follows:

	Rs.
Turnover	300,000,000
Net profit after the following income/expenses	6,000,000
<b>Income:</b>	
Dividend from resident companies	1,000,000
Interest on Treasury Bills	540,000
<b>Expenses:</b>	
Entertainment	100,000
Directors' emoluments	3,000,000
Book depreciation	1,200,000
Royalty paid	500,000
Provision for gratuity	500,000
Donation to government	200,000
Donation to an approved charity	600,000
Management fee paid	2,500,000
Interest paid to holding company (working capital loan)	400,000

**Notes:**

- The Company declared a gross dividend of Rs. 200,000 on 1<sup>st</sup> September 2018 using the dividends received from resident companies.
- Full depreciation has been claimed in the past years on all the assets other than the building constructed in 2013 at a cost of Rs. 5,000,000.
- Tax loss brought forward from 2017/2018 is Rs. 300,000.
- The company has made a self-assessed tax payment of Rs. 500,000 for the year.
- The company is engaged in a manufacturing business and the following information were extracted from its Balance Sheet.

Issued capital + reserves = Rs. 5,000,000

Holding Company loan = Rs. 20,000,000

**Calculate** the balance tax payable by ABC (Pvt) Ltd for the year of assessment 2018/19.

**Solution:**

(i) Adjustment of net profit for tax purposes (amounts in Rs.)	+	-
Profit before tax	6,000,000	
Dividend received (not a part of income)		1,000,000
Interest on Treasury Bills (non-business income)		540,000
<i>Add: Disallowable expenses</i>		
Excess interest		
Interest x $\frac{\text{Holding company loan} - 3 \times (\text{capital} + \text{reserves})}{\text{Holding Company loan}}$		
400,000 x $\frac{20,000,000 - (3 \times 5,000,000)}{20,000,000}$	100,000	
Entertainment	100,000	
Depreciation	1,200,000	
Provision for gratuity	500,000	
Donations (600,000 + 200,000)	800,000	
Less: Allowance for depreciation on building (5,000,000 x 10%)		500,000
<b>Total</b>	<b>8,700,000</b>	<b>2,040,000</b>
Less;	(2,040,000)	
<b>Assessable income from Business (adjusted profit)</b>	<b>6,660,000</b>	
Profit from business (adjusted)		6,660,000
Dividend received (not a part of assessable income)		-
Interest on Treasury Bills -		
		<u>600,000</u>
<b>Total Assessable Income</b>		<b>7,200,000</b>
<i>Less: Deductions;</i>		
Deduction of Losses B/f		(300,000)
Allowance for qualifying payments		
Donation to government (no limit)		(200,000)
Donation to approved charity Rs. 600,000 (Allowance limited to 1/5 of taxable income or Rs. 500,000, whichever is lower.)		(500,000)
<b>Taxable income</b>		<b>6,200,000</b>

**(ii) Tax on taxable income**

Since the assessable income from business of Rs. 6,660,000 is more than the taxable income, it is considered that the entire taxable income of the entity not having associates consists of such profit. Profit from a business of which turnover is less than Rs. 500 Mn is taxable at 14%. **Therefore, the tax on taxable income is Rs. 6,200,000 X 14% = Rs. 868,000.**

**(iii) Tax on dividends distributed**

Dividend has been paid against dividends received (net) from resident companies. Therefore, the company is not liable to dividend tax.

**(vi) Balance tax payable**

	<b>Rs.</b>	<b>Rs.</b>
Gross income tax liability		868,000
Less: Tax credits		
Self-assessment tax paid	500,000	
		(500,000)
Balance tax payable		368,000



## CHAPTER ROUNDUP

- ↪ A company is liable as in the case of every other person, for income tax on its profits and income for the year of assessment. There is no separate distinction or treatment in determining profits and income from any source of a company. Its determination is based on the general provisions of the Inland Revenue Act.
- ↪ As per the definition given in the Act, a company includes corporations, unincorporated associations & bodies, societies, organizations, funds and governments.
- ↪ The general rule as stated in Section 11 of the Inland Revenue Act provides all expenses incurred in the production of income of a person.
- ↪ The general scheme of the Inland Revenue Act is that income is liable to tax irrespective of the exhaustion or diminution of capital. An exception to this principle is however, made in the grant of depreciation allowance for certain capital assets.
- ↪ Every person carrying on or exercising any business is required to make up his accounts for the 12 months period ending March 31 of each year.
- ↪ Where the accounting basis adopted is consistent and is in conformity with generally accepted accounting principles and it is within the statutory rules for determining profits, such accounts will be acceptable to the Revenue Authorities.