

Taxing of Partnerships and Trusts

INTRODUCTION

This chapter explains the **taxing of partnerships and trusts** (not included in companies) under the Inland Revenue Act No. 24 of 2017.

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1 Introduction



As explained in Chapter 1 of this text (Section 195 of the Act) taxable persons are categorised for income taxation, as follows;

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

Further, as stated in chapter 1 of this text, 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 fraternity 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.

As a result, we have already covered the companies which includes most of the entities except **partnerships and trusts** and hence this chapter of the text is to cover those two entities.

Remarks:

For better clarity, note that that the concessionary tax rate 14% given under First Schedule to the Act (i.e. on Small and Medium Enterprises, business of exporting goods & services, agricultural business, providing educational services, promotion of tourism and providing information technology services) is not available for individuals and trusts.

- *In the case of **an individual** whether being a partner of a partnership or otherwise shall apply the standard tax slab rates (i.e. 4%, 8%, 12%, 16%, 20% and 24%) without enjoying above referred concessionary rate of 14%.*
- *Further, **trusts** are also not entitled for the above referred 14% concessionary rate and hence on entire taxable income, excluding the capital gains (@ 10%) shall apply the rate of 24%.*

2 Taxing of Partnerships (Section 53 to 56 & First Schedule)

Partnerships where twenty or more of the partners have limited liability for the debts of the partnership are included in to the definition of a company, which are already covered under chapter 1 & 2 of this text under companies and hence, all partnerships not included in to companies are to be taxed as partnerships as detailed below.

2.1 Introduction

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).

2.2 Taxable income of a partnership

As per Section 53 of the Act, partnerships **shall not be liable to pay income tax on its taxable income**. As a result, it shall not be entitled to any tax credit thereon.

However, it **shall be liable to pay** income tax [Sec. 53 (1) & (2)];

- with respect to withholding payments, and
- on capital gains (gain from the realisation of an investment asset), if any.

Partnership income/loss of a partnership for a year of assessment shall be the partnership's income from its business or investment for that year of assessment as detailed in Sections 6 & 7 and Subsection (5) of Section 19 of the Act. (Sec. 54). It is to be noted that as per Section 7 of the Act, the investment income includes capital gains. However, as per paragraph 2 of the First Schedule to the Act supported with Section 53 (2) such capital gains included in to the partnership's taxable income to be taxed to the partnership and not on the individual partners.

Amounts derived and expenditure incurred in common by partners shall be treated as amounts derived or expenditure incurred by the partnership and not by the partners, while the assets owned and liabilities owed in common by partners shall be treated as assets owned or liabilities owed by the partnership and not by the partners.

All business activities of a partnership shall be treated as conducted in the course of a single partnership business. Hence, for the purpose of income taxation, should prepare the adjusted profit for taxation along with the financial accounts by the partnership and allocate (distribute) the taxable result (profit/loss) to the individual partners for their taxation. At the individual partners' level, it is not needed to extract the gross income and the expenditure and prepare the accounts to work out the result (profit/loss) again.

Sharing of Profits/Losses;

- A partnership shall allocate the partnership income or loss (partnership's income/loss from its business or investment for that year of assessment under Section 6 & 7 and 19) to the partners according to the ratio of sharing profits/losses.
- However, other arrangements between a partnership and its partners such as loans made by a partner to a partnership and any interest paid with respect thereto and services provided by a partner to a partnership (including by way of employment) and any service fee or income from employment payable with respect thereto shall not be included in to partnership income and instead be treated as separate incomes.

Continuity of a Partnership;

- When a partnership continues after a change of partners, at least by two existing partners of the partnership, shall be treated as the same entity (Subject to any consequences under Section 63).

Withholding tax on Profits Allocated;

- The precedent partner or in the absence of such partner in Sri Lanka, an agent of the partnership in Sri Lanka, shall withhold tax in accordance with Section 84 of the Act and at the rate (8%) provided for in paragraph 10 of the First Schedule to the Act on each partner's share of any partnership income, excluding capital gains [Section 84 (1) (a) (ii)], if any.

Tax on Capital Gains;

- Capital gains tax (@ 10%), if any, is payable on assessment (self-assessment) by the partnership (paragraph 2 of the First Schedule to the Act) where no further taxes thereon to be paid by the individual partners and hence no tax credit is available to them.

Taxation of Partners;

- In calculating a partner's income from a partnership for a year of assessment;
 - : the partner's share of any partnership income shall be included, or
 - : the partner's share of any partnership loss shall be deducted.
- Gains on disposal of a partner's interest in a partnership (as computed in accordance with Section 56) shall be treated as income from a business and included in calculating the income of the partner and shall be calculated under Chapter IV of the Act.

Allocation of tax paid by a partnership;

- Tax paid under the provisions of this Act (WHT) and foreign income tax paid or treated as paid by the partnership with respect to the partnership income shall be allocated to the partners, proportionate to each partner's share, and shall be treated as paid by them. The allocation occurs at the time partnership income is treated as derived by the partners at the end of the partnership's year of assessment. [Sec. 55 (4) and 55 (3)(b)].

2.3 Tax on taxable income of a partnership

As stated above, a partnership **shall not be liable to pay income tax on its taxable income but shall be liable to pay** income tax with respect to withholding payments, and on capital gains (gain from the realisation of an investment asset), if any.

The precedent partner or in the absence of such partner in Sri Lanka, an agent of the partnership in Sri Lanka, shall withhold tax at 8% (Section 84 of the Act read along with paragraph 10 of the First Schedule to the Act) on each partner's share of any partnership income, excluding capital gains.

Each partner's share of any partnership income other than capital gain shall be included in to the partner's personal assessable income, tax computed and the 8% WHT deducted by the partnership allowed as a credit.

3 Taxing Trusts (Section 57 to 59 & First Schedule)

Unit trust or mutual fund to which Section 59 applies are included in to the definition of a company, which are already covered under chapter 1 & 2 of this text under companies and hence, **all trusts not included in to companies** are to be taxed as trusts as detailed below.

3.1 Introduction

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

As per Section 57 (1) of the Act, a trust shall be liable to tax separately from its beneficiaries and shall be taxed as an entity. As a result, the trust first pays the applicable income tax on its taxable income, then each beneficiary shall compute income tax on the income that they are receiving from the trust and pay after allowing the tax credit of the trust (applicable portion of the income tax paid by the trust).

3.1.1 Income Tax by the Trust

For the purpose of taxing a trust, **the amounts derived and expenditure incurred** by a trust or a trustee shall be treated as derived or incurred by the trust and not any other person, regardless of whether or not the amount is derived or incurred on behalf of another person and whether or not any other person is entitled to such an amount or income constituted by such an amount.

Separate calculations of income shall be made for separate trusts regardless of whether they have the same trustees. Subject to the provisions of the Act, arrangements between a trust and its trustees or beneficiaries shall be recognised for taxation.

3.1.2 Income Tax by the Beneficiaries [Sec. 57 (2) & (3)]

It is to be noted that a beneficiary of a trust may get two types of returns as follows;

- (i) **Income** of the trust
- (ii) **Distributions** of the trust

Taxing of Income of the trust in the hand of Beneficiaries [Sec. 57(2)]

The beneficiaries of a trust shall be liable to tax **on the income of the trust** to which that beneficiary is entitled from the trust.

For this purpose, the amounts derived and expenditure incurred by a trust or a trustee shall be treated as derived or incurred by the beneficiary and not the trust or trustee or any other person.

The amounts derived and expenditure incurred shall be allocated to the beneficiaries proportionately to each beneficiary's share, unless the Commissioner-General, by notice in writing and for good cause, directs otherwise.

Further, the tax paid under this Act and foreign income tax paid or treated as paid by the trust with respect to the trust's income shall be allocated to the beneficiaries at the end of the related year of assessment, proportionate to each beneficiary's share and treated as paid.

However, the above provisions shall not apply to a trust to the extent that the trust's taxable income includes a gain from the realisation of an investment asset (capital gain) and hence the capital gains of a trust and the tax paid there on shall not be treated as an income of the beneficiary/ies and no credit on the capital gain tax paid by the trust. [Sec.57(3)]

Taxing of Distributions in the hand of Beneficiaries (Sec. 58)

- **distributions of a resident trust** shall be exempt from tax in the hands of the trust's beneficiaries,
- **distributions of a non-resident trust** shall be included in calculating the income of the beneficiaries of the trust, except to the extent that the distribution represents an amount that is subject to tax to the trust/trustee under Section 57(1) or a beneficiary under Section 57(2).
- the **gains on disposal of the interest of a beneficiary** in a trust (capital gain) shall be included in calculating the income of the beneficiary.

3.2 Taxable income of a trust

As stated above, a trust shall be liable to tax separately from its beneficiaries and shall be taxed as an entity by applying the applicable income tax rate/s on its taxable income. However, a trust of an incapacitated individual not being a minor shall be taxed as an individual.

Like in any other entity, the taxable income of a trust may comprise of the assessable income from business, investment (including gains from realization of investment assets) or other income.

The business and investment income shall be computed in the same way as it is computed for a company which we have already discussed in Chapter 2 of this text. Here the expenditure incurred by a trust or a trustee on behalf of the trust shall be allowed against the amounts derived (income).

Similarly, the gains from realization of investment assets (capital gains) shall be computed in the same way as it is computed for a company, partnership or an individual.

3.3 Tax on taxable income of a trust

In calculation of the income tax, Section 2, being the charging section of the Act requires to apply the rate/s given in the First Schedule to the Act to the person's taxable income.

Accordingly, in the case of a trust we have to apply the rates given in paragraph 3 of the First Schedule to the Act where;

- 10% on capital gains, and
- 24% on other taxable income of a trust.



PROGRESS TEST

1 Develop the answers for the following questions.

- (1) A trust is a person for taxation under the Inland Revenue Act No. 24 of 2017. Establish the above as a valid statement?
- (2) In defining a partnership for taxation what is the most important character?
- (3) What income is a partnership liable to pay income tax?
- (4) Out of the possible transactions between a partnership and its partners what transactions are to be excluded from partnership profits?
- (5) Under the Inland Revenue Act on what profit is the WHT of 8% to be withheld by the precedent partner?
- (6) Can a partnership allocate and the individual partners claim a credit of the capital gain tax paid by a partnership?
- (7) Can the partners of a partnership include the capital gains of a partnership in to his/her tax return as a liable assessable income?
- (8) For the tax purposes under what circumstances would a partnership continue even after a change of partners?
- (9) Is the WHT deducting by the preceding partner a final tax and if not is the credit available on same?
- (10) Define a trust as given in Section 195 of the Act?
- (11) What are the incomes included in the taxable income of a trust?
- (12) What are the different rates of tax applicable on taxable income of a trust?
- (13) When a beneficiary **receives a distribution from a trust**, how are these taxed?
- (14) Are beneficiaries of a trust liable to pay income tax in their personal capacities on entire **income allocated to them by the trust**?

Discuss the above statement to highlight how far it is correct.

- (1) As per the interpretation given in Section 195 of the Act, a “person” means an individual or **entity** and includes a body of persons corporate or unincorporate, an executor, non-governmental organization and charitable institution;
Then the term “entity” is interpreted as follows;
An “entity” means a company, partnership or **trust**, but excludes an individual;
Accordingly, a trust is a person for taxation.
- (2) The most important character of a partnership for taxation is that it is carrying on business jointly for the purpose of making profit.
- (3) A partnership is liable to pay income tax on capital gains.
- (4) Following transactions to be excluded in partnership profits for taxation;
Any interest paid to partners on loans made by a partner to a partnership and services provided by a partner to a partnership such as employment and any service fee or income from employment payable with respect thereto.
- (5) WHT of 8% to be withheld by the precedent partner on each partner’s share of any partnership income, excluding capital gains.
- (6) A partnership can’t allocate and the individual partners can’t claim a credit on the capital gain tax paid by a partnership.
- (7) A partner shall not include the capital gains of a partnership in to his/her tax return as a liable assessable income.
- (8) For the tax purposes a partnership continues even after a change of partners under following circumstances;
After a change of partners, if it continues with at least two existing partners of the partnership, it shall be treated as the same entity.
- (9) The WHT deducted by the preceding partner is not a final tax and hence credit is available on same.
- (10) As per Section 195 of the Act, a trust means an arrangement under which a trustee holds assets?
- (11) The taxable income of a trust includes the gains from realization of investment assets and the taxable income where Section 57 applies (business, investment or other income)
- (12) The rates of tax applicable on taxable income of a trust are as follows;
 - On the gains from realization of investment assets @ 10%
 - On the balance taxable income @ 24%.

(13) When a beneficiary receives a distribution from a trust it will be taxed as follows;

- **distributions of a resident trust** shall be exempt from tax in the hands of the trust's beneficiaries,
- **distributions of a non-resident trust** shall be included in calculating the income of the beneficiaries of the trust, except to the extent that the distribution represents an amount that is subject to tax to the trust/trustee under Section 57(1) or a beneficiary under Section 57(2).

(14) Beneficiaries of a trust are liable to pay income tax in their personal capacities only on the income other than the capital gains allocated to them by the trust.

