

INCOME TAX LIABILITY OF RESIDENT COMPANY

Strategic Level – CA Sri Lanka

Corporate Taxation (SL 3)

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Learning Outcomes

Topic	Learning Outcomes
Income Tax Liability of a Resident Company	At the end of the session students should be able to; <ol style="list-style-type: none">1. Discuss different types of companies and the basis of their tax liability, including rates of income tax.2. Compute the assessable income from business and investment.3. Compute taxable income.4. Assess income tax liability, applying appropriate rates of income tax.5. Assess balance tax payable.

Introduction to Taxation

- **Tax** – A tax is a mandatory fee or financial charge levied by any government on an individual or an organization
- Objective of imposition of taxes/Functions of Taxation
 - Main Objective is collecting revenue for public works – Revenue and capital nature expenditure
 - Economic Objective – Control the economy/direction
 - Social Objective – Best behavior of the society
- **Imposition and administration**
 - **Imposed by Government** – As per Article 148 of the constitution (13th Amendments of the constitution)
 - **Administration** - Tax authorities
- **Type of Taxes** – Direct Taxes and Indirect Taxes

1. Imposition of Income Tax

1.1 Statutory Provisions applicable to Income Tax

a) Inland Revenue Act

The Act which is applicable to the imposition of income tax in Sri Lanka is the Inland Revenue Act, No. 24 of 2017 (IR Act). The IR Act has been introduced with effect from April 01, 2018.

- Inland Revenue Act, No. 24 of 2017
- Inland Revenue (Amendment) Act, No.10 of 2021 (Certified on 13th May 2021)
- Inland Revenue (Amendment) Act, No.45 of 2022 (Certified on 19th December 2022)

b) Gazette Notifications

From time to time, the Minister or administrators of income tax may issue gazette notifications with regards to the implementation of IR Act. Such gazette notifications would also become part of the legal framework for taxation

c) Circular

From time to time, for clarity and facilitating for the application of the tax law, Tax administrators of income tax may issue circular. Such circular also consider formation of the legal framework for taxations.

1. Imposition of Income Tax

1.1 Statutory Provisions applicable to Income Tax

d) Case Laws

Legislature (the Parliament) enacts laws, whereas the interpretation of such laws is vested with the Judiciary. Under Common Law (English Law) principles, the decisions of higher Courts become precedent and are considered examples in subsequent matters. Therefore, some of the cases on tax matters previously decided based on previous Inland Revenue Acts would also become part of the legal framework for tax.

e) Rulings

In order to achieve uniformity on contentious issues in administering the tax system, tax administrators being the Department of Inland Revenue (the IRD) may issue public rulings as well as private rulings. A ruling is a determination, or a method accepted by tax administrators for a particular scenario or an issue. Such rulings could be useful for Revenue officers as well as taxpayers in the future to identify similar issues or scenarios subject to certain restrictions.

1. Imposition of Income Tax

The Act which is applicable to the imposition of income tax in Sri Lanka is the **Inland Revenue Act, No. 24 of 2017**.

Charging Provision (Sec. 2(1))

Income tax shall be payable for each “**year of assessment**” by the following persons.

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

Accordingly, a “**person**” is chargeable with income tax when such person has taxable income or receives final withholding payment. The period of tax is identified as “**year of assessment**”.

1. Imposition of Income Tax

Income Tax Payable [Section 2(2)]

Total amount of income tax payable by a person for any year of assessment shall be :

- | | |
|-------------------------------------|------------|
| a) Tax on taxable income | xxx |
| b) Tax on final withholding payment | <u>xxx</u> |
| | <u>xxx</u> |

**Deducting any foreign tax credits allowable and any other tax credits allowable

Tax on taxable income = Taxable income X Tax rates[First schedule]

Tax on final withholding payment = Payment X Withholding Tax rates[First schedule]

Taxable income is calculated based on section 3 of the Act. The final withholding payments are defined in section 88 of the Act. The applicable tax rates are provided in the first schedule to the Act.

1. Imposition of Income Tax

Taxable income [Section 3].

Taxable income of a person for a year of assessment shall be equal to the total of the person's assessable income for the year from each employment, business, investment and other sources.

In arriving at Taxable income of a year of assessment Qualifying payment and relief for that year shall be deducted.

Taxable income of each person and assessable income of each source shall be determined separately.

3. Calculation of Income Tax Payable

Taxable Income (Sec. 3)

The taxable income shall be computed as follows.

Assessable income from “employment”	xxx
Assessable income from “business”	xxx
Assessable income from “investment”	xxx
Assessable income from “other sources”	<u>xxx</u>
Total Assessable Income	xxx
Less: Qualifying payments and reliefs under section 52 (5 th Schedule)	<u>(xx)</u>
Taxable Income	<u>xxx</u>

The taxable income of each person and the assessable income from each source shall be determined separately.

1. Imposition of Income Tax

Assessable income [Section 4].

Assessable income of a person for a year of assessment from employment, business, investment and other sources shall be equal to;

1. In the case of a **resident person**, the person’s income from employment, business, investment and other sources for that year, wherever the source arises
2. In the case of a **non - resident person**, the person’s income from employment, business, investment and other sources for that year, to the extent that the income arises in or derived from a source in Sri Lanka

Income source : employment, **business**, investment and other sources

3. Calculation of Income Tax Payable

Assessable Income (Sec. 4)

Assessable income of a person for a year of assessment from each source shall be based on such person's residential status.

a) For a resident person

The income from employment, business, investment or other source for the year **“wherever the source arises”**.

b) For a non-resident person

The income from employment, business, investment or other source for the year to the extent that the **“income arises in or is derived from a source in Sri Lanka”**.

2. Relevant Interpretations

Person (Sec. 195)

“Person” means an individual or entity and includes a body of persons Corporate or unincorporate, an executor, non-governmental organization and charitable institution.

Entity (Sec. 195)

“Entity” means a company, partnership or trust, but excludes an individual.

Person - Summary

- i. an individual
- ii. an entity
 - a) Company
 - b) Partnership
 - c) Trust
- iii. a body of persons corporate or unincorporated
- iv. an executor
- v. a non-governmental organization
- vi. a charitable institution

2. Relevant Interpretations

Body (Sec. 195)

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

Company (Sec. 195)

“**Company**” means,

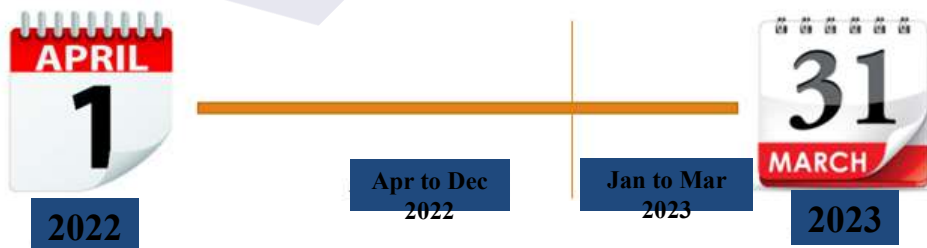
- a) a corporation, unincorporated association or other body of persons;
- b) includes;
 - i. a friendly society, building society, pension fund, provident fund, retirement fund, superannuation fund or similar fund or society; and
 - ii. a government excluding the Sri Lankan government, a political sub-division of a government, or a public international organization; but
- a) excludes a partnership or trust; and
- b) 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;

2. Relevant Interpretations

Year of Assessment (Sec. 20)

“**Year of Assessment**” is the period of twelve months commencing on the first day of April of any year and **ending** on the thirty-first day of March in the immediately succeeding year.

For example: *the year from April 1, 2022 to March 31, 2023 is the year of assessment 2022/2023.*



4. Resident status of a company

Resident Company [Section 69(4)]

A company shall be resident in Sri Lanka for a year of assessment if:

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

Non-Resident Company

A company deemed to be non-resident in the following circumstances:

- a) Companies' **registered office** or **principal office** is in outside Sri Lanka; and
- b) The **management and control** of its business is exercised outside Sri Lanka

5. Assessable Income

The assessable income of a **company** for a year of assessment is the aggregate of following elements:

- 1) Assessable income from **business**
- 2) Assessable income from **investments**
- 3) Assessable income from **any other source**

6. Calculate Assessable Income from Business

Assessable Income from Business

6. Calculate Assessable Income from Business

Calculation of the Assessable income from business

“Business” (Sec. 195)

- a) includes;
 - i. a trade, profession, vocation or isolated arrangement with a business character however short the duration of the arrangement;
 - ii. a past present or prospective business, but
- b) excludes; an employment.

If an activity amounts to a business, it cannot also be an investment. This is the incorporation of the **dominancy principle** in the provisions of the Act. One is dominant over the other. Hence, a person is just passively holding assets, in that case, he has an “investment” rather than a “business”. Accordingly, it is very important to understand what constitutes a business.

Any income that a person might derive from an asset without active engagement, it is considered as investment income. However, if an amount is derived in the context of a business which is “effectively” connection with a business, it is treated as business income irrespective of whether it is mentioned in section 7 which explains as the investment income.

6. Calculate Assessable Income from Business

What constitutes a business? (Sec. 6)

Business Income in calculating person's gains and profits from conducting a business the following shall be included:

- a) Service Fee
 - b) Consideration received in respect of trading stock
 - c) Gains from the realization of capital assets & liabilities of the business
 - d) Realization of depreciable assets of the business
 - e) Consideration for accepting a restriction of business capacity - *sometimes a person may receive some amount for agreeing not to do a business*
 - g) Gifts received in respect of business - *it is to be considered as a part of the business income, However, if the gift is in kind of a trading stock, a depreciable asset or business asset, then it will have a cost equal to the amount included in the income.*
 - h) Amounts derived that are effectively connected with the business and that would otherwise be included in calculating the person's income from an investment
 - i) Other amounts required to be included under the Act
- But excludes;**
- a) Exempt amounts and final withholding payments
 - b) Amounts included in calculating persons employment income

6. Calculate Assessable Income from Business

Calculation of the Assessable income from business

“Trade”

The term “trade” is not defined in the Act, therefore, in order to decide whether there is any trade or not, we must see that;

- a) whether a person has purchased some **commercial quantities** of items which are **more than enough** for him,
- b) if such articles are **held for a short period**,
- c) transactions are **repetitive**
- d) anything has been done to have a **saleable** item,
- e) any such **motivation to make profits**, etc.

If so, it can be determined that there is a trade.

7. Computation of gains and profits from business

In order to arrive at the assessable income from business, **all expenses incurred in the production of income are allowed as deductions (Sec. 11)**, including certain specific expenditure but prohibiting the deduction of certain other specified expenditure mentioned in the Inland Revenue Act.

Therefore, it is required to adjust the book profit / accounting profit to fit into the provisions of the Act to arrive at the assessable income for tax purposes. Accordingly, assessable income is computed as follows:

	(+)	(-)
Net profit before tax	xxx	
Less: exempt income/ final withholding payments, Other amounts that are included in the employment		xxx
Add: Disallowable expenses	xxx	
Less: Allowable expenses		xxx
Total	xxx	(xxx)
Assessable income from business	xxx	

8. Method of Accounting (Sec. 21)

Unless otherwise provided by the Act, the timing of inclusions and deductions in calculating a person's income shall be made according to generally accepted accounting principles.

“Generally accepted accounting principles” (Sec. 195):

“Generally accepted accounting principles” means;

- a) those adopted, from time to time, by CA Sri Lanka; and
- b) the International Financial Reporting Standards (IFRS);

Income from Business (Sec. 21(3))

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

9. Disallowable and Allowable expenses

- **Section 10 [General deduction]** : Refers to **disallowable expenses** and **rules** relating to expenses to be disallowed, which is **superseded the main deduction and special deduction rules** .
- **Section 11 [Main deduction]**: All **expenses** to the extent they **are incurred during the year in the production of income** from the business is allowable to deduct when ascertaining the income from business.
- **Section 11(2): No deduction** is allowed for an expense of **capital nature**, “Capital nature” includes an expense that secures a benefit capable of lasting longer than twelve months.
- **Section 12 to 19:** Are **special deduction rules** relating to certain specific expenses which is **superseded the main deduction rule**.

9. Disallowable expenses

Section 10 [General deduction] In calculating income from any source, following are not allowed.

- i. Domestic expenses (Sec. 197).
- ii. Tax payable under this Act and taxes or other levies specified by the CGIR
- iii. Interest, penalties and fines payable for breach of any written law in any country,
- iv. Expenditure incurred in deriving exempt or final WHT amounts,
- v. Retirement contributions (by the employer): (if the benefit is taxing on the employee or contributed to a fund approved by the CGIR, such contributions are allowed)
- vi. Dividends of a company,
- vii. Entertainment expenses or outlays,
- viii. Reserves or provisions,
- ix. Expenses incurred on lotteries, betting or gambling unless in the course of conducting such a business.
- x. Payment for which the person is required to withheld tax, deduction shall not be allowed for the respective expenditure until the tax is paid

9. Disallowable expenses

Domestic expenses to be disallowed:

- a) Where an individual incurs expenditure for himself:
- i. In maintaining him, including in providing shelter as well as meals,
 - ii. refreshment, entertainment or other leisure activities;
 - iii. In the individual commuting from home;
 - iv. In acquiring clothing, including shoes, for him, other than clothing that is not suitable for wearing outside of work;
 - v. In educating him, other than education that is directly relevant to a business conducted by him and that does not lead to a degree or diploma; or
 - vi. In paying any personal debts, including credit card debts, of the individual.
 - vii. In paying any interest incurred with respect to money borrowed by him and used for himself,

It is considered as domestic expense.

9. Disallowable expenses

Domestic expenses to be disallowed:

- b) Where **another person** incurs expenditure in **making payment** to or **providing any other benefit** for an individual, the **expenditure is domestic** except to the extent that:
- i. the payment or benefit is **included** in calculating the **income of the individual**;
 - ii. 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.

9. Disallowable expenses

Taxes to be disallowed:

- a) Income tax payable under the Inland revenue Act (Instalments, interest, penalty, WHT).
- b) Taxes or other levies specified by the Commissioner General [Extraordinary 2064/54 01.04.2018]
 - i. Any income tax or similar tax payable to another country – double tax avoidance agreement (other than excess over maximum amount of the credit is allowed)
 - ii. Economic Service Charge
 - iii. VAT on Financial Services
 - iv. NBT on Financial Services
 - v. Crop Insurance Levy
 - vi. Supper gain tax, Bars and Taverns Levy, Casino Industry Levy, Mobile Telephone Operator Levy, Satellite Location Levy, Dedicated Sports Channel Levy and Mansion Tax (*charged on large houses costing over 150 million rupees to build*).

10. Deductions which are specifically allowed

Certain expenses are specifically mentioned as allowable deductions. In such a situation, the conditions specific in such specific deduction provisions should be fulfilled and thereby the general deduction rule under Section 11 is not applied.

9.1 Interest Expense (Sec. 12)

Interest expenses incurred by a **person** during a year of assessment under a debt obligation is deductible if the money borrowed was **utilized for the production of income or to acquire an asset for business and the assets was used during the year** in the business.

9. Deductions which are specifically allowed

9.2 Financial Cost - Allowable finance cost - (Sec. 18)

This is applicable to business or investment income of an **entity** other than a financial institutions.

The amount of financial cost attributable to the financial instrument is to be limited to the formula for the Y/A 2022/2023:

Total Financial Cost	XXXXX
Less.	
1. Debt obligation not used for purchase an assets	
2. or used for purchase an assets but assets is	
3. not employed for the production of income during the year	XXXX
2. Debt obligation not relevant to business	<u>XXXX</u>
Allowable finance cost	XXXXX

9. Deductions which are specifically allowed

9.2 Financial Cost - Thin Capitalization (Sec. 18)

Other than a company the above cost is allowable deduction for tax purposes. In case of the company deductible amount has a limitation

$$\left. \begin{array}{l} \text{Allowable Finance Cost} \\ \text{attributable to financial} \end{array} \right\} = \frac{\text{Total Financial Cost}}{\text{Total Cost of Financial Instruments}} \times [(\text{Total of the issued Share Capital} + \text{reserves}) \times 4]$$