

# Introduction to Taxation

## Part 02

### AAT Level III

#### Corporate & Personal Taxation (CPT)

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## CHAPTER 02 IMPOSITION OF INCOME TAX

### CHAPTER CONTENT

- ✓ Applicable income tax law
- ✓ Imposition of income tax
- ✓ Residence rule

### 1.0 APPLICABLE INCOME TAX LAW

Inland Revenue Act No. 10 of 2006 was repealed with Inland Revenue Act No. 24 of 2017. The New Act, effective from 01.04.2018 (From Year of Assessment 2018/2019).

### 2.0 IMPOSITION OF INCOME TAX (CHARGING SECTION - SECTION 02)

The liability of income tax in Sri Lanka is based on the charging section (section 2) of the “**Inland Revenue Act, No. 24 of 2017**”.

Under section 2, income tax is payable for each **year of assessment** by;

- (a) A person who has taxable income for that year of assessment, or
- (b) A person who receives a final withholding payment during the year.

The income tax payable is equivalent to;

- (a) (Taxable Income x Rate/s\*) – tax credits, if any  
 PLUS
- (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 income tax (IT) on the income that arises in/from Sri Lanka. (Sec. 4)

#### Question 1

Determine the composition of income tax payable for any year of assessment, according to the Inland Revenue Act No.24 of 2017.

#### Question 2

Explain the residency rule applicable to any person?

Question 3

“Charging Section gives you a brief understanding about the tax system.” Determine the important factors have been discussed in this Section?

**2.1 INTERPRETATIONS RELEVANT TO CHARGING SECTION (SECTION 195)**

- (i) **Who is liable? - every person**
- (ii) **How frequently should the tax be computed? - for every year of assessment**
- (iii) **On what should the tax be computed? - in respect of taxable income & final withholding payments**
- (iv) **At what rate should the tax be computed? - at the rates specified in the First Schedule**

**2.1.1 WHO IS LIABLE FOR INCOME TAX?**

**Definition of Person (Sec 195)**

The word “Person” defined under the Inland Revenue Act as follows.

**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)

**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).

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

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

By looking at above definition, the following persons are chargeable with income tax.

- ✓ an individual
- ✓ a company
- ✓ a partnership
- ✓ a trust
- ✓ an executor or administrator
- ✓ a co-operative society
- ✓ an association, club or society of persons whether corporate or unincorporated
- ✓ a charitable institution

**Question 4**

Determine whether “partnership is liable to pay income tax as a “person” under the above provision.

**Question 5**

Interpret/describe the following wordings with regard to income tax of Sri Lanka?

- Person
- Company

**2.1.2 PERIOD OF TAX/ YEAR OF ASSESSMENT**

Period of tax for income tax purpose is a “Year of Assessment”. “Year of Assessment” means 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.

Year of assessment 2018/2019 refers to the period from April 01, 2018 to March 31, 2019.

**Question 6**

Describe the wording of Year of Assessment with a relevant example.

**2.1.3 ON WHAT INCOME TAX IS PAYABLE**

As per the Charging section income tax shall be payable for each year of assessment by a person who has;

- Tax on Taxable income

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	xxxx
Less : Qualifying Payments & Reliefs ( Sec 52 with 5 <sup>th</sup> schedule)	<u>(xxx)</u>
(Deductions from taxable income)	
<b>Taxable Income</b>	<b><u>xxx</u></b>
<b>Tax on Taxable Income</b>	<b>= Taxable Income x Tax Rates = xxxx</b>
Less : Any foreign tax credit under section 80	(xxx)
Any other tax credit allowed under the Act	<u>(xxx)</u>
<b>Income Tax Payable</b>	<b><u>xxx</u></b>

*Points to note*

- i. Any tax paid in other country can be deducted as a foreign tax credit as per section 80 whether there is any double tax agreement or not with the other country.*
- ii. Tax credit allowed under this Act shall be as per section 89 of the Act. (credit for non-final withholding tax)*
- iii. A person may deduct economic service charge under the ESC Act from income tax payable.*

- Tax on Final withholding payment

Tax on final withholding payment is computed as follows.

Final withholding payment x tax rates as per First Schedule    xxxx

Meaning for “final withholding payments” (Sec. 88)

The following shall be the final withholding payments.

(a) Dividends paid by a resident company to a resident person

(b) Interest paid to or treated as being derived by-

(i) a resident individual (other than such amount of interest paid to a senior citizen by a financial institution up to Rs. 1,500,000 per annum).

(ii) a charitable institution.

(c) Amounts paid as winnings from a lottery, reward, betting or gambling (other than amounts received in conducting a business consisting of betting and gaming).

(d) Payments made to non-resident persons that are subject to withholding or payments made by individuals not in the course of business to nonresident persons (other than payment derived through a Sri Lankan permanent establishment).

**Question 7**

As per the IRD Act No.24 of 2017, Determine the composition of Assessable income.

**Question 8**

Determine the final withholding payments applicable for individuals.

**Question 9**

A company has following particulars relevant to the year of assessment 2018/2019.

- Taxable income of Rs. 30,000,000 which is taxable at the rate of 28% as per first schedule.
- Withholding tax on interest received of Rs. 2,800,000.
- Economic service charge of Rs. 9,000,000 which includes the amount brought forward from the year of assessment 2017/2018.

Calculate income tax payable for the year of assessment 2018/2019

**2.1.4 AT WHAT RATE INCOME TAX IS PAYABLE (FIRST SCHEDULE TO THE ACT)**

**2.1.4.1 Tax Rates for resident and non - resident individuals**

**2.1.4.1.1 Normal Rates**

Taxable Income	Rates	Tax
1 <sup>st</sup>	600,000	4% 24,000
2 <sup>nd</sup>	600,000	8% 48,000
3 <sup>rd</sup>	600,000	12% 72,000
4 <sup>th</sup>	600,000	16% 96,000
5 <sup>th</sup>	600,000	20% 120,000
On Balance		24%

**2.1.4.1.2 Employment Income at Reduced Rates**

Following types of income shall be tax at the reduced rates,

- Amount Received in commutation of pension
- Amount Received as a retiring gratuity
- Amount received as compensation for loss of office or
- Amount received as withdrawal from EPF & ETF

The aggregation of above benefits tax at reduced rates as,

**If period of Contribution / Employment 20 years or less,**

	<u>Retirement Benefits</u>	<u>Rates</u>
On First	2,000,000	NIL
Next	1,000,000	5%
On	Balance	10%

**If period of Contribution / Employment more than 20 years,**

	<u>Retirement Benefits</u>	<u>Rates</u>
On First	5,000,000	NIL
Next	1,000,000	5%
On	Balance	10%

**2.1.4.1.3 Income from realization of Investment Assets.**

- However, where an individual’s taxable income includes gains from the realization of investment assets shall be taxed at the rate of 10%.

**2.1.4.1.4 Income from Betting and Gaming, Liquor and Tobacco - 40%**

**2.1.4.2 Tax Rates for Partnerships**

- Share of partnership income by each partner is subject to **WHT @ 8%**
- Realization of investment assets shall be taxed at the rate of 10%.

**2.1.4.3 Income Tax Rates of Trusts**

- On Taxable Income tax @ 24%
- Realization of investment assets shall be taxed at the rate of 10%.

**2.1.4.4 Income Tax Rates of Unit Trusts or Mutual Funds**

- Income from realization of investment assets shall be taxed at the rate of 10%.
- On Taxable Income tax @ 28%

**2.1.4.5 Income Tax Rates of Charitable Institutions**

- Income from realization of Investment Assets shall be taxed at the rate of 10%.
- On Taxable Income Tax @ 14%

**2.1.4.6 Income Tax Rates of Non - Governmental Organizations**

- Income from realization of Investment Assets shall be taxed at the rate of 10%.
- On Taxable Income Tax @ 28%

**2.1.4.7 Income Tax Rates of ETF, Provident or Pension and Termination Funds**

- On Taxable Income @ 14%

**2.1.4.8 Remittance Tax**

- The rate of tax payable by a non-resident person on remittances of profit, tax at the rate of 14%

**2.1.4.9 Tax Rates for Companies**

1. Small and Medium Enterprises                      14%
  - As per section 195, **“Small and Medium Enterprise”** means a person who satisfies the following conditions,
    - 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;
      - ✓ The person does not have an associate that is an entity; and
      - ✓ The person’s annual gross turnover is less than Rs. 500,000,000;



2. A company **predominantly** conducting a business of **exporting goods and services**    **14%**
3. A company predominantly conducting an **agricultural business** – **14%**
4. 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%**;
5. A company predominantly providing **educational services** – **14%**
6. A company predominantly engaged in an undertaking for the **promotion of tourism- 14%**
7. A company predominantly providing **information technology services-14%**.

**As per Section 195,**

1. 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;
2. 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;
3. “predominantly” means 80% or more calculated based on gross income.
4. Where a company’s taxable income includes gains from the realization of investment assets, then –
  - (a) those gains, shall be taxed to the company at the rate of 10%; and
  - (b) only the remainder of the company’s taxable income shall be taxed at the rate referred in above.

#### 2.1.4.10 Withholding Tax Rates

1. Deduction of withholding Tax (WHT) from Investment Returns

Any of the following payments which has a source in Sri Lanka and which is made by a person (Withholding Agent) to any Resident or Non - Resident person.

- Dividend - 14%
- Interest or Discount - 5%
- Natural Recourse Payment - 14%
- Rent - Payment made to a resident person - 10%
- Rent - Payment made to a non - resident person - 14%
- Royalty - 14%
- Charge, premium or retirement payment - 14%
- Amounts as winning from a lottery, reward, betting or gambling - 14%
- Sale price payable to the seller of any gems sold at an auction conducted by the National Gem and jewellery Authority - 2.5%

2. Deduction of Withholding Tax (WHT) from Service Fees and Contract Payments.

Any of the following service fees or contract payments made by a person ( WHT Agent) to any resident individual - Tax Rate 5%,only if the total payment to any individual ( withholdee) exceeds Rs.50,000/- (exclusive of VAT) per month.

- Payment for teaching, lecturing, examining, invigilation or supervising an examination.
- Payment as a commission or brokerage to a resident insurance, sale or canvassing agent.
- Payment as an endorsement fee.
- Payment in relation to the supply of any article on a contract basis through tender or quotation.
- Payment for any service of construction work, security service, janitorial service, consultation work of any kind, organizing of events, catering, designers, dress makers, tour guidance, entertainment, agency function or any similar services or connected work where such services are provided under an agreement or otherwise.
- Payment for any management services
- Payment for any type of vocational services provided as an independent service provider.

Other Rates under service fees and contract payment

- Any service fee or insurance premium, with a source in Sri Lanka, made by a person ( WHT Agent) to a Non – Resident person – 14%  
 This tax rate should be applied subject to the maximum restriction fixed in the relevant DTAA.
- Payment with a source in Sri Lanka made by a person ( WHT Agent) to a Non – Resident person who conducts transport business ( Land, Sea, Air) or telecommunication business – 2%

**3.0 TAXATION OF RESIDENT & NON-RESIDENT**

If a person including a company is a resident person for income tax purposes, he or it is liable to pay income tax on “income from employment, business, investment or other sources wherever arising”. That means he or it is liable to pay income tax on profits and income which arises in Sri Lanka as well as outside Sri Lanka.

If a person including a company is a non-resident person for income tax purposes, he or it is liable to pay income tax on “income from employment, business, investment or other sources that arise or derived from Sri Lanka.

**Question 10**  
 Determine whether profits from employment received by a person resident in Sri Lanka by rendering service outside Sri Lanka does fall within the scope of Income Tax in Sri Lanka.

**3.1 RESIDENCY RULE APPLICABLE TO AN INDIVIDUAL (SECTION 69)**

An individual shall be a resident in Sri Lanka for a year of assessment if the individual;

- resides in Sri Lanka;
- is present in Sri Lanka during the year and that presence falls within a period or periods amounting in aggregate to one hundred and eighty-three days or more in any twelve-month period that commences or ends during the year;
- is an employee or an official of the Government of Sri Lanka and his spouse is posted abroad during the year; or
- is an individual who is employed on a Sri Lanka ship, within the meaning of the Merchant Shipping Act, during the period the individual is so employed.

**Question 11**

Given below is a summary of the overseas travel details of Mr.Silva, a citizen of Sri Lanka, and determine whether he is a resident person or not for the year of assessment 2018/2019.

Date of Departure	Date of Arrival
01.04.2018	15.04.2018
01.05.2018	25.06.2018
29.06.2018	15.08.2018
17.08.2018	17.10.2018
24.03.2019	15.04.2019

**3.2 RESIDENCY RULE APPLICABLE TO COMPANIES (SECTION 69)**

As per the Section 69 of the Act, a Company is deemed to be resident for tax purposes, if;

- (i) it is incorporated or formed under the laws of Sri Lanka;
- (ii) it is registered or the principal office is in Sri Lanka; or
- (iii) at any time during the year the management and control of the affairs of the company are exercised in Sri Lanka.

**Question 12**

Determine the tax implication on following scenarios.

- a). A company resident in Sri Lanka has provided consultancy services outside Sri Lanka for a fee of USD 10,000.

Advise whether the said income falls within the scope of chargeability of income tax.

- b). A company non-resident in Sri Lanka has carried out business in Sri Lanka and earned profit of USD 250,000 thereon.

Advise whether the said income falls within the scope of chargeability of income tax.

- c). A non-resident individual has earned a fee of USD 1,500 in providing professional service abroad

Advise whether the said income falls within the scope of chargeability of income tax.