

SESSION 02: SOURCES OF INCOME

(Assessable Income from Business)

Lecturer:

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Learning Outcomes

At the end of the lesson, the students should be able to:.

1. Identify the different income item under the business income.
2. Identify the disallowable expenses under the business income (sec 10).
3. Understand the specific expenses allow to deduct under the business income.
4. Calculate the assessable income from business.

Content

1. Definition of Business
2. Types of income item under business income
3. Main deductions (Sec.10)
4. General deductions (Sec.11)
5. Specific deductions (Sec.12,13,14,15,16,17,18,19,24)
6. Calculate the assessable income from business

Corporate Income Tax (CIT)

- Corporate Income Tax (CIT) calculation builds on fundamental corporate taxation principles and focuses on systematically assessing income, beginning with a company's core business operations. The purpose of this structured approach is to ensure tax computations are accurate, legally compliant, and defensible under scrutiny.
- Because tax legislation is complex and applies differently to various business transactions, a step-by-step method is essential. A structured process helps to:
 - Reduce errors in income assessment
 - Avoid incorrect deduction claims
 - Minimize risk of penalties
 - Ensure reliable financial reporting
 - Support risk management and governance

✓ Tax calculation is not just accounting — it is a risk management activity.

Corporate Income Tax (CIT)

- The CIT calculation follows a logical essential stage progression:
 - ❖ ***Assess income from business operations*** - Calculate assessable income from a company's primary commercial activities using revenue recognition principles and expense deduction rules.
 - ❖ ***Assess income from investment activities*** - Determine income from investment sources including dividends, interest, and rent, applying relevant tax treatments.
 - ❖ ***Determine taxable income*** - Consolidate all assessable income and apply qualifying payments.
 - ❖ ***Calculate tax liability & Compute balance tax payable*** - Apply corporate tax rates to taxable income and adjust for advance payments and other credits to compute the balance tax payable.
- Each stage must be completed correctly before moving to the next.

Definition of Business

- Business is defined section 195 of the Act as follows;

"business"

A. Includes

- I. 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

According to the above definition, it is important to understand the business in terms of "trade", "profession" and "vocation".

Trade

Factor to be considered reference to trade

- **What is sold** – Purchase of commercial quantities of product that cannot be used personally.
- **Length of ownership** – If asset is held for a short period of time, it suggest trade rather than an investment.
- **Repetition** – Repetition of transaction suggests a trade.
- **Supplement work** – Trade often process of works turn assets into saleable products.
- **Motivation activity** – Trade requires assets or concludes contracts with the intention of a making a profit.
- **Motivation for sale** – Trades typically sell assets for the same reason they acquire, them, in order to make a profit.

Profession and Vocation

- Any person engaged in professional activity with his special skills and knowledge, it is his profession. He may have obtained such a skill from an institution following a course or a program.
- A vocation is an occupation, either professional or voluntary, that is carried out more for its altruistic benefit than for income, which might be regarded as a secondary aspect of the vocation, however beneficial.

Example

1. In the case of a Bank or a Financial Institution, it is a mandatory requirement to maintain minimum amount of investment in Government Securities to show the capital adequacy. Accordingly, the interest income earned on such investments is effectively connected to the business. As such, though it is an interest income, it will be a business income.
2. In the case of a manufacturing company, if the additional warehouse space was rented out for a shorter period, the rent income earned thereon is effectively connected with the business and as such, the said rent income will be a business income.

Assessable Income from Business

Assessable income from business represents the statutory starting point for calculating a company's tax liability. The Inland Revenue Act, No. 24 of 2017 defines this as the gross income from any business for a year of assessment, less exempt amounts and final withholding payments. You must understand this concept thoroughly as it determines the base upon which all subsequent tax calculations depend.

To understand this concept:

- Assessable income represents **gross income from business and investment sources for a year of assessment, excluding exempt amounts (3rd Schedule) and final withholding payments (Sec 88)**, as defined by the Inland Revenue Act. Adjustments for **disallowed expenses, allowable deductions and qualifying payments (Sec.52)** are applied after assessable income is determined, when **computing taxable income**.
- In practice, **accounting profit (PBT)** is often used as a reconciliation tool to derive taxable income; however, statutorily, assessable income is determined based on **gross income less exempt amounts and final withholding payments** in accordance with the Inland Revenue Act.

Assessable Income from Business

Adjustment/Detail	(+)	(-)
Accounting profit before tax	XXXX	-
<u>Adjustment</u>	XXX	-
Disallowed expenditure		
Specially allowed expenses		XXX
Income not categorized as business/Non taxable income		XXX
Taxable income for tax purpose	XXX	
	<u>XXXX</u>	<u>XXX</u>
Adjusted Profit/(Loss)for tax purposes	<u>XXXXXX</u>	

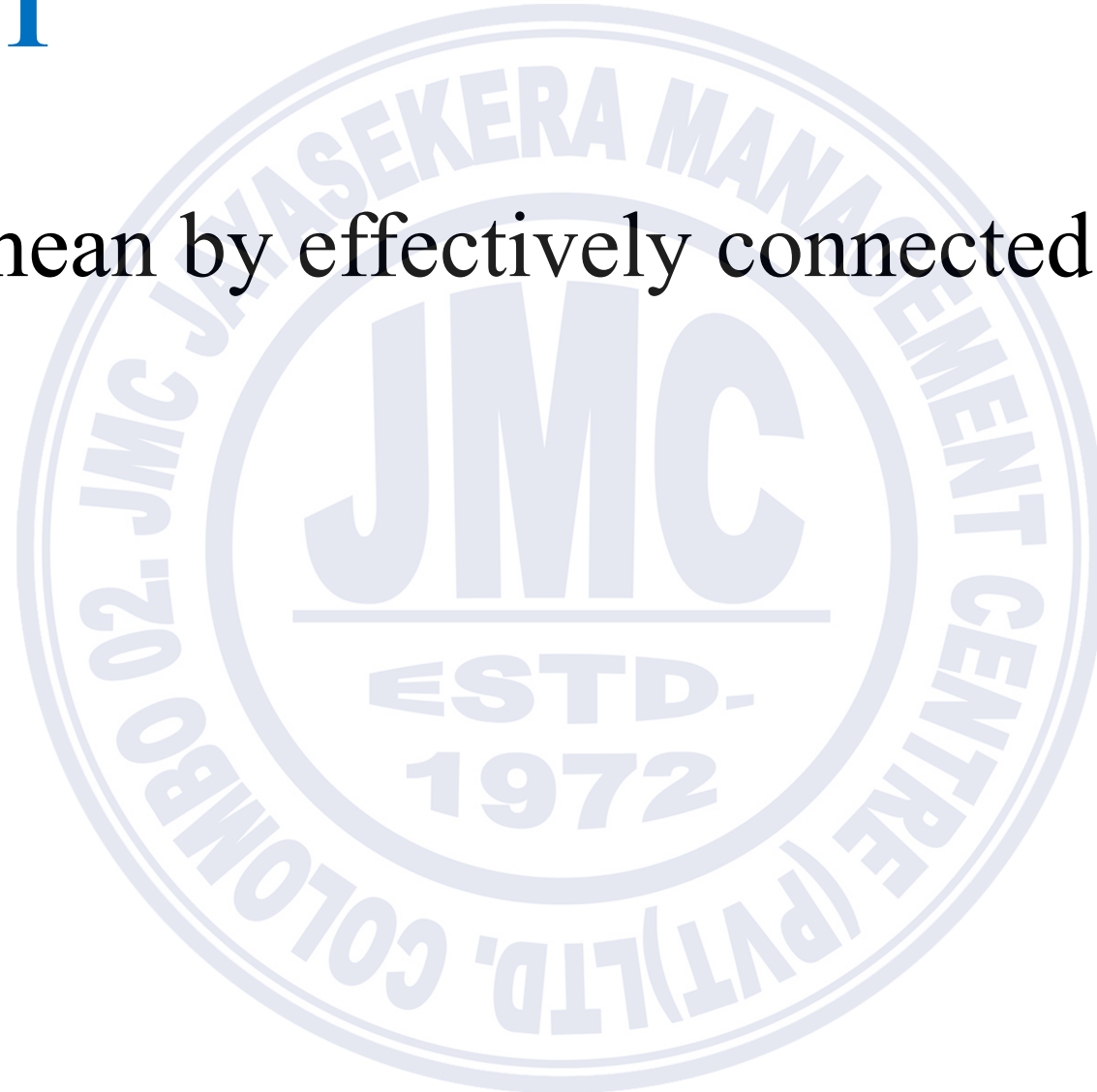
Type of Business Income (*Section 6*)

The following amounts shall be included in calculating the gains and profits of a person from conducting a business for a year of assessment.

- service fees;
- consideration received in respect of trading stock;
- gains from the realization of capital assets and liabilities of the business.
- amounts required to be included by the 4th schedule on the realization of the person's depreciable assets of the business;
- amounts derived as consideration for accepting a restriction on the capacity to conduct the business;
- gifts received by the person in respect of the business;
- 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
- other amounts required to be included under the Act.

Question 01

What does it mean by effectively connected with the business?



Answer

Effectively connected test is a question of nexus of association. Therefore, if an amount is derived in the context of business, it is treated as business income.

Method of Accounting (Sec.21)

- Unless otherwise provided by this Act, the timing Method of inclusions and deductions in calculating a person's income shall be made according to generally accepted accounting principles (Sec.21 (1)).
- An individual shall account for income tax purposes on a cash basis in calculating the individual's income from an employment or investment (Sec.21 (2)).
- An individual or entity conducting business shall account for income tax purposes on an accrual basis (Sec.21 (3)).
- A person shall account for income tax purposes the income from sources other than the sources referred to in subsections (2) and (3) on either a cash or accrual basis, whichever properly computes the person's income (Sec.21 (4)).
- Subject to subsections (2) and (3), the Commissioner- General may by written notice require a person to use a particular method of accounting or may approve an application of a person to change the person's method of accounting. The Commissioner-General shall be satisfied that the new method is necessary to properly compute the person's income (Sec.21 (5)).

Accrual Basis Accounting (Sec.23)

- ❑ Under the accrual basis of accounting, a person –
 - (a) derives an amount when it is receivable by the person; and,
 - (b) incurs an expense or other amount when it is payable by the person.
- ❑ An amount shall be receivable by a person when the person becomes entitled to receive it, even if the time for discharge of the entitlement is postponed or the entitlement is payable by instalments (Sec.23 (2)).
- ❑ An amount shall be treated as payable by the person when all the events that determine liability have occurred and the amount of the liability can be determined with reasonable accuracy, but not before economic performance with respect to the amount occurs (Sec.23 (3)).

Economic Performance Occurs (Sec.23(4))

For the purposes of subsection (3), economic performance occurs –

- (a) with respect to the acquisition of services or assets, at the time the services or assets are provided;
- (b) with respect to the use of an asset, at the time the asset is used; and
- (c) in any other case, at the time the person makes payment in full satisfaction of the liability.

Systematic Revenue Recognition

Revenue recognition for tax purposes follows these steps:

- Analyse sales ledgers, contracts, and bank statements to identify all revenue streams from goods, services, and other business operations.
- Apply the correct statutory timing rules to recognise revenue when earned or entitled, not necessarily when cash is received.
- Document the basis for revenue recognition with supporting evidence such as invoices, delivery notes, and performance obligations met.

Allowable Expense Analysis

An allowable expense is expenditure incurred wholly and exclusively in the production of assessable income from a business. The burden of proof rests with the taxpayer to demonstrate that each claimed expense meets statutory criteria. You must verify that every deduction claimed can withstand scrutiny during a tax audit.

Key areas to examine include:

- Verify the expense was incurred directly in generating business income and not for capital nature, personal, or domestic purposes.
- Confirm the expense is revenue in nature, meaning it maintains rather than enhances the income-earning capacity of assets.
- Obtain and maintain valid supporting documentation including tax invoices, receipts, and contracts for every claimed deduction.

Disallowed Expense Adjustment

Certain expenditures are explicitly prohibited as deductions under tax law, even if they appear in the accounting records as business expenses. These include capital nature expenditure, domestic expenses, personal expenses, and specific statutory exclusions. You must identify and add back these items to the accounting profit to arrive at the correct assessable income.

The required procedures are:

- Review the general ledger for capital items such as asset purchases, improvements, or expenses that create enduring benefits.
- Identify personal or domestic expenses, entertainment costs, and fines or penalties paid.
- Addback accounting depreciation and other non-deductible provisions to the net profit figure in your tax computation

Expenses

- **General Deduction (*Sec. 10*)**
- **Main Deduction (*Sec. 11*)**
- **Specific Deductions (*Sec. 12,13,14,15,16,17,18,19 & 24*)**

General Deduction (Sec. 10)

The following expenses shall not be deducted in computing a person's income [Sec. 10(1)(b)]

- I. Domestic expenses (Sec. 197)
- II. Tax payable under this Act;
- III. Interest penalties and fines payable to any government or a political subdivision in relation to breach of any written law.
- IV. A deduction for a payment from which WHT is required withheld shall not be allowed until the withheld tax has been paid to the Commissioner General.
- V. Expenditure or any other deduction to the extent incurred by a person in deriving exempt amounts or final withholding payments;
- VI. 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, gratuity or savings fund or a savings society, which is approved by the Commissioner-General subject to any specified conditions;
- VII. Dividends of Company
- VIII. Outlays or expenses for entertainment "entertainment" means the provision to any person to any person of food, beverages, tobacco, accommodation, amusement, recreation or hospitality or any kind" (Sec. 195)
- IX. an amount that a person has transferred, in his financial accounts, to a reserve or provision for expenditures or losses not yet incurred but expected to be incurred in a future year of assessment;
- X. Amounts incurred on lotteries, betting or gambling, other than amounts incurred from conducting a business of lotteries, betting or gambling.
- XI. Taxes or other levies specified by the Commissioner General and any tax or levy which is not allowed to be deducted in calculating a person's income in terms of any other written law.

Domestic Expenses (Sec. 197)

Where an individual incurs expenditure in respect of himself, the expenditure shall be domestic expenditure to the extent that it is incurred.

- in maintaining the individual, including in providing shelter as well as meals, refreshment, entertainment of other leisure activities;
- in the individual commuting from home;
- in acquiring clothing, including shoes, for the individual, other than clothing that is not suitable for wearing outside of work;
- in educating the individual, other than education that is directly relevant to a business conducted by the individual and that does not lead to a degree or diploma; or
- in paying and personal debts, including credit card debts, of the individual.

Domestic Expenses (Sec. 197) Contd.

Where another person incurs expenditure in making a payment to or providing any other benefit for an individual, the expenditure shall be domestic expenditure except to the extent that –

- The payment or benefit shall be included in calculating the income of the individual.
- The individual provides consideration of an equal market value for the payment or benefit; or
- The amount of the expenditure is so small as to make it unreasonable or administratively impracticable to account for it.

Main Deduction (Sec. 11)

- 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 (Sec. 11(1)).
- No deduction shall be allowed under subsection (1) for an expense of a capital nature (Sec. 11(2)).
- In this section, “expense of a capital nature” includes an expense that secures a benefit capable of lasting longer than twelve months (Sec. 11(3)).

Specific Deductions (Sec. 12 to 19)

1. Interest Expenses (Section 12)
2. Allowance for trading stocks (Section 13)
3. Repairs and improvements (Section 14)
4. Research and Development expenses and agricultural startup expenses (Section 15)
5. Marketing and Communication Expenses (Section 15A)
6. Capital allowances and balancing allowances (Section 16)
7. Losses on realization of business assets and liabilities (Section 17)
8. Deductible amount of financial cost (Section 18)
9. Business or investment losses (Section 19)

Interest Expenses (Sec. 12)

For the purposes of section 11, the interest incurred by a person during a year of assessment under a debt obligation of the person shall be deemed to be incurred in the production of income to the extent that –

- (a) the money borrowed under such debt obligation was used to acquire an asset that is used during the year in the production of income; and
- (b) in any other case, the debt obligation was incurred in the production of income.

Example

Mr. Nimal is carrying on a business of selling computer accessories. He obtained a bank loan and utilized the loan proceeds as follows during the year 2024/25.

- ❖ 50% for construction of new office building.
- ❖ 25% for payment of salaries to the staff.
- ❖ 25% for his private purposes.

During the year of assessment 2024/25, he paid Rs. 300,000 as interest for the loan. During the year of assessment 2025/2026 he sold the office building and paid the loan interest for the year is Rs. 250,000.

Answer

During the year of assessment 2024/2025, under Section 12(a) Mr. Nimal is entitled for a deduction amounting to Rs. 150,000 (50% of the Loan) paid as interest on the funds used to construct the new office building as it is an asset used during the year. Similarly, (Sec. 12).

- a) permits a deduction for the interest paid on the funds used to pay the staff salaries amounting to Rs. 75,000 because those funds are used in the production of income from the business. Interest paid amounting to Rs. 75,000 on the funds used for his private purposes is not deductible.
- b) Further, he is not entitled for a deduction of Rs. 75,000 paid as interest on the funds utilized for private purpose during the year of assessment 2024/2025 as such activity is not used during the relevant year in the production of income for the business.

Deductible Amount Of Financial Cost (Sec. 18)

- ❑ In addition to the section 12, Section 18 is also applicable to deductibility of interest expense of entities.
- ❑ The amount of financial costs deducted in calculating the income of a company (other than financial institution) which is incorporated in or outside Sri Lanka and having an issued share capital as at the date on which the year of assessment ends, from conducting a business or investment for a year of assessment commencing from April 1, 2021, shall not exceed the limit given below.

Financial cost of the year

value of financial instruments incurred during the year. (4 x total of the issued share capital & reserves of the company).

- ❑ any amount unutilized in the current year may be carried forward up to six years, subject to the same thin capitalization restriction.
- ❑ This rule does not apply to **Financial Institutions**.

Example

Company B is a garment factory and incurs interest expense amounting to Rs. 2,500,000 during the year of assessment 2025/26. Financial position of the company as at 31.03.2026 revealed as follows.

Stated Capital	5,000,000
Reserves	3,000,000
Long Term Loans	40,000,000

Allowance for Trading Stock (Section 13)

- The allowance shall be calculated as –

Opening value of trading stock of the business for the year of assessment	=	XXXX
plus: expenses incurred during the year on trading stock of the business	=	XX
		XXXXXX
less: closing value of trading stock of the business for the year	=	(xxx)
Allowance for trading stock	=	XXXX

- The deduction for the cost of trading stock is not allowed until it is disposed.
- The section provides rules for determining the cost of trading stock and such rules are in line with generally accepted accounting principles.

Allowance for Trading Stock (Section 13)

- The opening value of trading stock of a business for a year of assessment shall be the closing value of trading stock of the business at the end of the previous year of assessment (Sec.13(3)).
- The closing value of trading stock of a business for a year of assessment shall be the lower of – (Sec.13(4)).
 - (a) the cost of the trading stock of the business at the end of the year; or
 - (b) the market value of the trading stock of the business at the end of the year.
- Where the closing value of trading stock is determined in accordance with paragraph (b) of subsection (4), the cost of the trading stock shall reset to that value (Sec.13(5)).

Repairs & improvements (Section 14)

- Expenses for the repair or improvement of depreciable assets and meeting the requirements of subsection (1) of section 11 of a person for any year of assessment shall be deducted irrespective of whether they are of a capital nature or not.
- **"improvement"** means the expenditure incurred by a person to make additions or alternations to a depreciable asset which enhances the value of such asset, but excludes the expenditure incurred to maintain or repair a depreciable asset which temporarily enhances the value of such asset.

Repairs & improvements (Section 14.(2))

- The deductions of improvements referred to in subsection (1) granted for any year of assessment commencing from April 1, 2021; and with respect to a depreciable asset of a person –

Shall not exceed –

- in the case of improvement to a Class 4 depreciable asset, five percent of the written down value of the asset at the end of the previous year (paragraph 4(3) of the Fourth Schedule);
- in all other cases, twenty percent of the written down value of the asset at the end of the previous year (paragraph 4(3) of the Fourth Schedule);

***** Excess expense for which a deduction shall not be allowed as a result of the above limitation shall be added to the depreciation basis of the asset year (paragraph 3 of the Fourth Schedule).**

Repairs & improvements (Section 14 (4))

- In the event of the written down value referred to in subsection (2) is zero for a depreciable asset, notwithstanding the provisions of subsection (2), the deduction for improvement referred to in subsection (1) shall be deducted in equal amounts apportioned over-
- Improvement cost need to deduct subject to following limit:
 - (a) twelve years of assessment, for a Class 4 depreciable asset;
 - (b) three years of assessment, for other Classes of depreciable assets, commencing from the year of assessment in which the expenditure was incurred.

Research & Development Cost (Section 15)

- "research and development expenses" means expenses incurred by the person in –
 - a) carrying on any scientific, industrial, agricultural or any other research for the upgrading of the person's business through any institution in Sri Lanka (or for any innovation or research relating to high value agricultural products, by the person or through any research institution in Sri Lanka); or
 - b) the process of developing the person's business and improving business products or process which shall be beneficial to Sri Lanka, but shall exclude expenses incurred that are otherwise included in the cost of an asset under the Act.
- The section 15 permits the research and development cost even if it is a capital nature expense. However, it does not allow deducting the cost of purchasing of equipment used for the research, its capital allowances claimed on those assets.

Agricultural Startup Expenses (Section 15)

"Agricultural startup expenses" means; (Section 15(2) of the Act)
expenses incurred by the person in –

- a) Opening up any land for cultivation or for animal husbandry;
- b) Cultivating land referred to in paragraph (a) with plants;
- c) the purchase of livestock or poultry to be reared on land referred to in paragraph (a); or
- d) maintaining tanks or ponds or the clearing or preparation of any inland waters for the rearing of fish and the purchase of fish to be reared in such tank, pond or inland waters, as the case may be;

For any kind of business start-up expense is allowable to deduct under section 11. But, under section 11, capital nature expenditure included in start-up expenses is not deductible. Section 15, as the most specific section is applicable on agricultural start-up expenses and as such, even capital nature expenses included in agricultural start-up expenditure are deductible.

Marketing and Communication Expenses (Section 15A)

For any year of assessment commencing on or after April 1, 2021, in calculating a person's income from a business, marketing and communication expenses incurred by such person in the production of income during the year of assessment shall be deducted irrespective of whether they are of a capital nature or not.

Advertisement and Communication Expenses

(Section 15A (2))

In this section, “marketing and communication expenses” means, any expenses incurred by any person in-

- (a) carrying out a market research by such person or any institution in Sri Lanka on his behalf;
- (b) the development or production of marketing, advertising and communication campaign to the extent that such development or production is carried out in Sri Lanka;
- (c) advertising on mainstream media or social media including television, radio, print or as outdoor advertising;
- (d) product launches or campaign activation carried out by such person or by any local institution on his behalf;
- (e) development and printing of point of-sale material by such person or by any local institution on his behalf.

Capital allowances and balancing allowances

(Section 16)

As per section 16, Capital allowances and balancing allowances are allowed to be deducted in calculating a person's income from a business only.

Capital allowances are:

- granted in respect of depreciable assets owned and used by a person at the end of a year of assessment in the production of the person's income from a business; and
- calculated in accordance with the provisions of the second, fourth or sixth Schedule to the Act.

Depreciable assets means;

"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 excludes goodwill, an interest in land, a membership interest in an entity and trading stock".

Capital allowances and balancing allowances

(Section 16)

Capital allowances granted with respect to a particular year of assessment shall be taken in that year and shall not be deferred to a later year of assessment (Sec.16 (3)).

The total of the Capital allowances granted and calculated under the Fourth Schedule to this Act in respect of a depreciable asset shall not exceed the cost of such depreciable asset in any circumstances (Sec.16 (3A)).

Capital allowances and balancing allowances

(Section 16)

According to the fourth schedule to the Act, following should be considered in calculating the capital allowance.

Straight line method and following formula should be used.

Capital allowance = A/B

- A = Depreciation basis of the asset at the end of year of Assessment (it never can be revalued amount).
- B = Number of years relevant to each depreciable asset.

Number of years applicable to calculate capital allowance – on or after 01/04/2018

Class	Depreciable Assets	Number of Years
1	computers and data handling equipment together with peripheral devices	5
2	buses and minibuses, goods vehicles; construction and earthmoving equipment, heavy general purpose or specialized trucks, trailers and trailer mounted containers, plant and machinery used in manufacturing.	5
3	railroad cars, locomotives and equipment, vessels, barges, tugs, and similar water transportation equipment, aircraft, specialized public utility plant, equipment and machinery, office furniture, fixtures and equipment; any depreciable asset not included in another class.	5
4	buildings, structures and similar works of a permanent nature	20
5	intangible assets, excluding goodwill	The actual useful life of the intangible asset, or where the intangible asset has an indefinite useful life, 20.
6	milking machines with latest technology, used to manufacture local liquid milk related products w.e.f. 01.04.2021.	2

Number of years applicable to relevant to calculate capital allowance before 01/04/2018

	Category of assets	2011/2012 2017/2018
1	Plant machinery equipment - construction industry - Export industry - other	33 1/3% 50% 33 1/3%
2	Motor vehicle or furniture	20%
3	Any qualified building constructed	10%
4	Certain building purchased	6 2/3%
5	Software imported	25%
6	Software developed in Sri Lanka	100%
7	Information technology equipment, calculating equipment & accessories	25%
8	Any intangible asset (other than Goodwill)	10%

Capital allowances and balancing allowances

(Section 16)

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;
- d. a heavy general purpose or specialized truck or trailer; or
- e. a motor cycle.

For the purposes of this paragraph, “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.

Depreciation Basis of a Depreciable Asset

The depreciation basis of a depreciable asset of a person at the end of a year of assessment is shall be the sum of—

- (a) the depreciation basis of the asset at the end of the previous year of assessment; and
- (b) amounts added to the depreciation basis of the asset during the year of assessment in respect of additions to the cost of asset.

Balancing Allowances and Assessable Charges

Where a depreciable asset of a person is realized by the person before the end of a year of assessment-

- (a) an assessable charge is included in calculating the person's income for the year calculated in accordance with the following formula: or
- (b) a balancing allowance is granted to the person for the year calculated in accordance with the following formula:

$$A - B$$

'A' is consideration received by the person during the year of assessment for the asset; and,

'B' is the written down value of the asset at the time of realisation of the asset.

Balancing allowances and Assessable Charges

Sales proceeds		XXXX
<u>(-) Tax written down value</u>		
Cost	XXXX	
(-)Acc: Capi: Allowance	<u>(XX)</u>	<u>(XXX)</u>
Assessable charge/ (Balancing allowance)		XXXX

Business or Investment Losses (Section 19)

Section 19 provides the deduction of loss in calculating the person's income from business or investment. Two types of losses may be incurred in the context of business or investment.

1. Losses from realization of assets or liabilities of the business or investment.
 2. Total loss incurred on business or investment.
- Loss deduction rules
 - A. An unrelieved loss of the person for the year from a business can be deducted from any other business of that person.
 - B. An unrelieved loss of the person for any of the previous six years of assessment can be deducted from the business or any other business.

"Unrelieved loss" means the amount of a loss that has not been deducted in calculating a person's income. Accordingly, only the loss calculated under the Act, No. 24 of 2017 can be deducted under section 19.

Trade debtor write-off expenses (Section 24)

A person other than a person conducting banking business can claim write-off of debt as bad debt if such person has taken reasonable steps to recover and the person reasonably believe that recovery is not possible (Sec. 24).



Q&A?
Thank you