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Realisation of Assets & Liabilities

Chartered Accountancy
Strategic Level
Corporate Taxation (TAX)

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CORPORATE TAXATION
Strategic Level
June 2022

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4. REALISATION OF ASSETS AND LIABILITIES

The proceeds and gains arising on the realization of specified assets are liable to tax either as business income or investment income. The law identifies the following amounts derived to be amounts that must be considered as income.

Business income

- Consideration received in respect of trading stock
- Gains from the realization of capital assets and liabilities of the business
- Amounts derived on the realization of depreciable assets.

Investment income

- Gains from the realization of investment assets

6.1. Capital Gains

For income tax purposes capital gain is treated as an investment income. The type of income is enumerated in paragraph (b) of subsection (2) of section 7 under source of investment income, as follows:

"(b) gains from realization of investment assets as calculated under Chapter IV"

Accordingly, Capital gains tax (CGT) is charged on the gains arise from realization of investment assets.

The "investment asset" is defined in section 195 of the Act as follows:

"investment asset -

(a) means 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 at least two of those three years (calculated on daily basis)"

As defined in section 195,

"capital asset means 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. option, right or other interest in an asset referred to in the foregoing paragraphs; but excludes trading stock or a depreciable asset"

6.2. General Rules (Sections 36-41)

Division I of Chapter IV of the Act deals with general introduction to this Chapter. The gain is calculated as the consideration received for the asset or liability exceeding the cost of the asset or liability at the time of realization.

In deciding the gain, the following factors need to be considered:

- Whether the asset is an investment asset as defined.
- the asset utilized prior to the realization was not in any manner connected to the business
- The gain calculated as explained below is does not exceed Rs. 50,000/- for resident individual

6.2.1. Calculation of gains and liability (Section 36)

A gain is realized when an asset is sold or exchanged at a price higher than its cost. Similarly, a loss occurs when an asset is sold for less than its cost. Gains or loss can be categorized as a business income or investment income. If it is an investment income the gain is a capital gain and if it is effectively connected to a business income, it is a trade profit and not a capital gain.

Therefore, a gain can be defined as a "Consideration received (Sec 38) for the asset or liability exceeds the cost of the asset (Sec 37) or the liability (Sec 40) at the time of realization (Sec 39)"

Consideration received	=	********
Less:		
Cost of an asset or Liability	=	********
Gain or loss	=	********

Calculating capital gains

A company which is engaged in the manufacture of toys has disposed a block of land for a sum of Rs. 100 million during the year of assessment 2021/2022. The cost of the asset is Rs. 80 million.

Advise the gain that should be included in calculating income of this company for the year of assessment 2021/2022.

Calculating capital gain

A company which is engaged in the manufacture of articles has disposed shares invested in a company for a sum of Rs. 80 million during the year of assessment 2021/2022. The cost of the asset is Rs. 100 million.

Advise the implication of the loss for this company for the year of assessment 2021/2022.

A loss on the realization of assets is calculated under a similar formula.

The gain on the realization of any investment asset should not be included in any gain that is considered for employment or as business income.

If an asset or liability is used in the production of two or more sources of income, the cost and consideration received shall be apportioned between each source according to the market value of the parts used to produce each source.

A loss arising from an investment can be set off against income from investment.

6.2.2. Cost of the assets and liability (Section 37)

Section 37 specifies the manner of calculating the cost of an asset. Accordingly, the cost of an asset includes expenditure that incurred in acquiring of an asset, further it can be an improvement or any incidental expenses. The term incidental expenses have been defined in the Section 37(4) itself. Example: Advertisement expenses, transfer tax, stamp duty etc. Subsection 2 of the section 37 further elaborates a situation where an income amount also can be considered as a cost of an asset.

Following are the examples:

- Amount included in **person's income** (Employment/Business/investment/other income)
  Ex: Land given to employee as part of an employment income
- Amount received as **exempt income**– Third Schedule
  Ex: Bonds to diplomatic person as part of remuneration
- Amount received as final Withholding payment
  Ex: Lottery winning, rewards

When determining the gain on the realization of an asset, a person is entitled to claim a deduction on account of the costs incurred. The IRA details the expenses that can be claimed as costs and it includes;

a. Expenditure incurred by the person in acquiring the asset, including expenditure on construction, manufacture or production of the asset,
b. Expenditure incurred by the person in altering, improving, maintaining or repairing the asset
c. Incidental expenditure incurred in acquiring and realising the asset. In this context, the term "incidental expenditure" has been defined to include the following types of expenditure.
    - Advertising expenditure, transfer taxes, duties and other expenditure of transfer
    - Expenditure of establishing, preserving or defending ownership of the asset
    - Remuneration for the services of an accountant, agent, auctioneer, broker, consultant, legal advisor, surveyor or valuer, relating to expenditure referred to above
d. Any income included in calculating the person's income or which s exempt or subject to final withholding payment and which has resulted in a person acquiring the asset for another, or incurring expenditure mentioned in (b) or (c) above, on behalf of the person.

The law precludes the following from being considered when determining the cost of an asset;

i. Consumption expenditure

ii. Excluded expenditure
iii. Expenditure to the extent that it is deductible in calculating a person's income
iv. Expenses included in the cost of another asset

Calculation Summary of Section 37

Expenditure incurred to acquire the asset (Including construction, manufacturing or production of the asset)	=	*********
Add: Expenditure incurred to altering the asset (Improving, maintaining, repairing)	=	*********
Add: Incidental expenditure (acquiring or realizing) (Advertising, transfer taxes, lawyer fee …)	=	*********
Add: Income amount	=	*********
Cost of an asset	=	*********

Special Note: Transitional Provisions - sec 203 (4)

According to the above provisions the cost of an investment asset held by a person as at, September 30, 2017 is equal to the market value of the asset at that time.

Capital Gain – Cost of the asset

Mr. Perera purchased a land for Rs 3,500,000 on 12.12.2015 and this was held by him as an investment. The land and building value as at 30.09.2017 was Rs 4,000, 000. Mr Perera sold asset for Rs 6,000,000 on 01.05.2021 and incurred following expenditure before selling;

- Advertisement Rs 100,000,
- Brokerage fee Rs 60,000 and
- legal fee Rs 75,000.

Compute the Capital Gain for the year of assessment 2021/22.

6.2.3. Consideration received (Section 38)

Consideration received can be cash received or receivable by the person for an asset. The concept of consideration can be in the form of exchange of one property instead of payment of cash to another. In such a situation the market value of the asset will be considered as the consideration received.

Consideration received for an asset shall be,

(a) Amount received or receivable on the realisation -cash

In the case of consideration received other than cash - market value

Ex: Exchange of asset to another asset

(b) Amount received in respect of owning the asset

Ex : Altering ,repairing

(c) Amount received or entitlement to receive in future – advance

i. Grant of an option

ii. Consideration received for an asset shall not include an exempt amount or final WHT.

Capital Gain – Consideration received

Company A is engaged in the business as a land developer. During year 2018 it gives Mr Silva, one of its executives, a plot of land as a bonus. The market value of the land is Rs 2 million. Mr Silva sells the land in year 2021 for Rs2.2 million.

Compute the Capital Gain of Mr Silva for the year of assessment 2021/22.

For the realization of an investment asset, the consideration received shall be the amount received or receivable by the person in respect of such asset or the assessed value at the time of realization whichever is higher. The "assessed value" has been defined to mean the value at the time of the realization, certified by a professionally qualified valuer in a valuation report.

However, if the tax official may determine the consideration received for an asset if he is of the opinion that the assessed value is not indicative of the market value of the asset.

Further, consideration received for the grant of an option in relation to an asset is considered realization proceeds only if the person has not been subject to tax on the proceeds or related gains

Where consideration is received which represents a combination of consideration and a sum which is either exempt or subject to final withholding tax, such component referred to in the latter, would not form part of the amount considered as consideration.

6.2.4. Realization (Section 39 and 43)

Capital gain arises when assets are sold. Section 39 (a) and (b) deal with the situation where a person parts with the ownership of the asset physically by way of it being sold, exchanged, transferred, destroyed, lost, expired etc. The death of person considers as realization of asset immediately before the death.

Deemed realization

Section 39(c) to 39 (f) discusses the matter of deemed realization. This means that ownership of the assets is not actually transferred to another person, but for income tax purposes it is deemed that realization has taken place.

Time of realization (section 39)

In the case of capital assets and liabilities, depreciable assets and investment assets, gains relating to same, are considered income at the time of realization. The law has identified the following as being the point of realization for income tax purposes.

a. The parting of ownership in the asset, including when the asset is sold, exchanged, transferred, distributed, cancelled, redeemed, destroyed, lost, expired, expropriated or surrendered.
b. Where a person ceases to exist, including by reason of the death of an individual, immediately before the person ceases to exist
c. In the case of an asset other than trading stock or a depreciable asset, the receipt of consideration received from owning the asset exceeds the cost of the asset.
d. In the case of an asset that is a debt claim owned by a person, the person reasonably believes the debt claim will not be satisfied, where the person has taken reasonable steps in pursuing the debt claim and the person writes the debt off as bad
e. In the case of trading stock, depreciable asset, a capital asset of a business or an investment asset, immediately before the person begins to employ the asset in such a way that it ceases to be an asset of any of the respective categories.
f. Where there is a change in tax residency status.

6.3. Special rules on realization

6.3.1. Realisation with retention of asset (Section 43)

Where a person realizes an asset with a right to retention, the transaction would be treated as follows;

a. The person would be considered to have realized an amount equal to the market value of the asset at the time of realization; and
b. Would be treated as re-acquiring the asset and incurring expenditure of the amount equal to the sales proceeds derived on the acquisition.

Capital Gain – Realisation with retention

Mr Kumar is a resident individual who owns an apartment in Sri Lanka as well as India. He leaves Sri Lanka and decides to move India permanently Sec 70(3) in August 2021.

Determine whether any of his assets are realized in the year of assessment 2021/22.

According to Section 43, Mr. A is treated as realizing apartment situated in India immediately before he ceases to be resident in Sri Lanka but not his domestic asset in Sir Lanka. Even though Mr. Kumar does not sell his apartment situated in India actually, according to section 39(f) it is considered as a realization. (deemed realization)

6.3.2. Transfer of assets to an associate or transfer by gift (Section 46)

Where there is a transfer of an asset to an associate or the transfer is a gift, the transaction is to be considered as follows;

a. The person making the transfer would be considered as deriving an amount equal to the greater of the market value of the asset, or the net cost of the asset, immediately before the realization and
b. The person acquiring ownership of the asset shall be treated as incurring an expenditure of an equal amount in relation to the acquisition of that asset

6.3.3. Transfer of assets to an associate of an individual or a charitable institution (Section 46)

Section 46(2) provides an exception to the general rule for an individual who transfer land or a building situated in Sri Lanka to an associate or a charitable institution. Where there is a transfer of assets in land and building situated in Sri Lanka by a person to an associate who is an individual, or where there is a gifting of assets to a charitable institution, the transaction is to be treated as follows;

a. The individual who is making the transfer shall be treated as deriving an amount in respect of the realization equal to the net cost of the asset, immediately before the realization, and
b. The associate or the charitable institution shall be treated as incurring an expenditure of an equal amount in acquiring the asset.

For this purpose, the recipient would be considered an associate where the relationship is that of a child by marriage or adoption, a spouse, a parent, a grandparent, grandchild, sibling, aunt, uncle, nephew, niece or first cousin.

For the transfer of any other capital asset, other than land and building by any other person, section 46(1) will apply and the gain is to be calculated as follows;

a. The person making the transfer would be considered as deriving an amount equal to the greater of the market value of the asset, or the net cost of the asset, immediately before the realization and
b. The person acquiring ownership of the asset shall be treated as incurring an expenditure of an equal amount in relation to the acquisition of that asset

Capital Gain – Transfer of asset to associate or charitable institution

Mr. Peiris has transferred the following assets to his son during the year of assessment 2021/22;

Asset	Net Cost	Market Value
Land and building	5 Mn	10 Mn
Family Home	3 Mn	4 Mn
Unlisted shares	2 Mn	4 Mn

Compute the capital gain of Mr. Peiris for the year of assessment 2021/22.

6.3.4. Transfer of assets to an associate maintaining beneficial ownership (Section 46)

Where a person realizes an asset being interest in trading stock, depreciable asset, investment asset or capital asset of business, by way of transfer of ownership of the asset to an associate of the person and specified conditions are met, the transaction would be treated as follows;

a. The person making the transfer shall be treated as deriving an amount in respect of the realization equal to the net cost of the asset immediately before the realization.
b. The associate shall be treated as incurring expenditure equal to the same sum in acquiring the asset.

The specified conditions are as follows;

- The person or the associate is an entity
- The asset or assets are trading stock, depreciable assets, investment assets or capital assets of the business of the associate immediately after transfer by the person
- At the time of transfer, the person and the associate are residents, or in the case of an associate partnership, none of its partners are exempt from income tax, and
- Underlying ownership in the assets continue to be at a threshold of at least 50%.

6.3.5. Involuntary realization of asset with replacement (Section 47)

Where a person is supposed to realise an asset and subsequently acquires a replacement asset of the same type within six months before or within one year after the realization, and elects in writing to make use of the provisions in the law, that person shall be treated as

a. Deriving an amount in respect of the realization equal to the aggregate of the net cost of the asset immediately before realization and the amount (if any), by which amounts derived in respect of realization exceed expenditure incurred in acquiring the replacement asset, and
b. Incurring expenditure in acquiring the replacement asset equal to the aggregate of,
    (i) The sum referred to above in (a), and
    (ii) The amount (if any) by which expenditure incurred in acquiring the replacement asset exceeds amounts derived in respect of the realization.

The Commissioner General may specify the circumstances in which the replacement of one security in a company with another security in the same company or different companies constitute an involuntary realization.

There may be a situation where a person receives money or another capital asset asset (or both) as compensation when a person disposes of an asset involuntarily (or under an insurance policy against the risk of such an event happening). In this case, the person may be able to defer the liability to pay tax on any capital gain arising on the disposal subject to following conditions;

- Realize an asset in manner set out in Sec 39 (a)
- Acquires a replacement asset of same type, within six months before or after one year of realization.
- Need to lodge a written election stating your choice

If above conditions are satisfied.

Realization = Net cost + If Compensation received exceeds cost of replacement asset

Cost of replacement
asset = Net cost + If cost of replacement asset exceeds compensation received

Involuntary realization with replacement Mr. Sunil purchased a building and the net cost of the building is Rs 2,500,000. The value as at 30.09.2017 Rs 3,000,000. This building was destroyed in August 2021 due to fire and it was insured and the insurance claim received amounts to Rs. 3,000,000. Mr. Sunil rebuilt the building at a cost of Rs 2,500,000. Assumed that all three conditions are satisfied. **Compute** the Capital Gain for the year of assessment 2021/22 and the cost of the replacement asset.

6.3.6. Realisation by separation (Section 48)

Where rights and obligations with respect to an asset owned are assigned to another person, including by way of lease of the asset or part thereof, the transaction would be treated as follows;

a. Where the rights or obligations are permanent, the one person shall be treated as realizing part of the asset but shall not be treated as acquiring any new asset or liability, and
b. Where the rights and obligations are temporary or contingent, the person shall be treated as acquiring a new asset and incurring a new liability.

The rights and obligations are considered to be permanent when they are likely to last for more than 50 years.

6.3.7. Transfer of asset to spouse or a former spouse (Section 44)

Where there is a transfer of asset consequent to a death, divorce, settlement or bona-fide separation agreement between an individual and a spouse or former spouse, and an election is made to utilize relief mentioned hereunder by the spouse or former spouse, the transaction would be treated as follows;

a. The individual shall be treated as deriving an amount in respect of the realization equal to the net cost of the asset immediately before the realization, and
b. The spouse or the former spouse shall be treated as incurring expenditure equal to the same amount in acquiring the asset.

6.3.8. Transfer of asset on death (Section 45)

Where an individual realizes an asset on death by way of transfer of ownership of the asset to another, the transaction would be treated as follows;

a. The individual shall be treated as deriving an amount in respect of the realization equal to the net cost of the asset at the time of realization, and
b. The person acquiring ownership of the asset shall be treated as incurring expenditure of the same amount in the acquisition.

6.3.9. Provision of assets as security (Section 49)

Where a person grants a mortgage or similar form of security over an asset to secure a debt owed to another person, the transaction would be treated as follows;

a. The first person shall not be treated as realizing the asset or any part of it but treated as still owning the asset and having incurred liability being the secured debt, and
b. The other party shall not be treated as owning the asset or any part of it but shall be treated as owning the secured debt.

Provision of assets as security

A company has granted a mortgage over its property to obtain a loan from a bank.

Advise applicable realisation and owning the asset or liability in the hands of the company and the bank in terms of section 49 of the Act.

6.3.10. Transfer by way of finance lease or instalment sale (Section 49)

As in the case of an instalment sale, when an asset is leased under a finance lease, the lessor is treated as transferring ownership of the asset to the lessee.

A transaction under either category would be treated as follows;

a. The person shall be treated as deriving an amount in respect of the transfer equal to the market value of the asset immediately before the transfer, and
b. The person who acquires the asset shall be treated as incurring the same amount in acquiring the asset.

Where the lessee under a finance lease returns the asset to the lessor before ownership passes to the lessee, the lessee shall eb treated as transferring ownership of the asset back to the lessor.

6.3.11. Transfer of assets between an entity and its shareholders and vice-versa (section 63)

Where there is a realization on account of a transfer of assets between an entity and one of its members or vice-versa, the realization would be subject to tax as follows;

a. There transferor shall be treated as deriving an amount in respect of the realization equal to the market value of the asset immediately before the realization, and
b. The transferee shall be treated as incurring expenditure of the same amount.

6.4. Costs of trading stock (Section 42)

Section 42 of the IRA carries provisions relating to determining costs of trading stock. In terms of such provisions, the cost relating to trading stock should be determined on the same basis as in the case of other assets, using the absorption cost method. There if specific provisions that prohibits the inclusion of costs relating to repair, improvements or depreciation of depreciable assets being considered.

A person could elect to determine the cost of trading stock or any other type of asset specified by the CGIR that are fungible and are not readily identifiable, using the "first in first out" method; or the average cost method. Once a selection is made, the basis shall continue to apply and can be changed only with the written permission of the CGIR.

For this purpose, the following terms have been defined;

- Absorption cost method means the generally accepted accounting principle, under which, the cost of trading stock is the sum of direct asset cost, direct labour cost and other factory overhead costs.

- The Average cost method means the generally accepted accounting principle, under which, costs are allocated to fungible assets of a particular type owned by a particular person, based on the weighted average costs of all the assets of that type owned by that person
- Direct labour cost means expenditure incurred on labour that directly relate to the production of trading stock.
- Direct asset cost means expenditure incurred by a person in acquiring any asset or assets that constitute trading stock or becomes an integral part of trading stock produced
- Factory overhead cost means all expenditure incurred by a person in producing trading stock, except direct labour and direct asset costs, and
- "First in first out method" means, the generally accepted accounting principle under which costs are allocated to a fungible asset of a particular type owned by a person based on the assumption that assets of that type are realized in the order of their acquisition.

6.5. Apportionment of costs and consideration received (Section 51)

Where a person acquires a number of assets under one arrangement, the expenditure incurred in acquiring each asset is to be apportioned between the assets according to their market values at the time of acquisition.

Similarly, where a person realizes a number of assets under a common arrangement, the amount derived shall be apportioned between the assets according to the market values at the time of realization.

Where a person owns an asset and realizes part of it, the net cost of the asset immediately before the realization shall be apportioned between parts of the assets realized as parts retained, according to their market values immediately after realization.

6.6. Compensation payment and adjustment made to assets and liabilities (Section 41)

The recovery of actual expenditure incurred or expected consideration for an asset or liability, or a loss in value of an asset or increase in liability, or any compensation payment relating to same, is to be considered as proceeds realized on an asset or liability, unless there is a contrary provision in the Act.

Where a person includes expenditure in the cost of an asset or liability and later recovers part of same, the person is required to include the amount recovered as consideration received for the asset of liability as the case requires.

Where a person includes an amount derived as consideration received for an asset or liability and later refunds part of the amount, the person may include the amount refunded to the cost of the asset.

6.7. Liabilities (Section 40)

The cost and consideration received for a liability shall be treated in the same way as the cost and consideration received for an asset. In this context, the following would apply;

a. Reference to asset would carry reference to a liability
b. Expenditure incurred in the realization of a liability is included in the cost of the liability, and
c. Amounts derived in respect of incurring the liability are included in the consideration received for the liability.

A person who owes a liability shall be treated as realizing the liability,

a. When the person ceases to owe the liability including when the liability is transferred, satisfied, cancelled, released or expired
b. In the case of a liability of a person who ceases to exist including by reasons of death, the liability shall be considered as realized immediately before the person ceases to exist
c. Where there is change in the residency status of a person.

Capital Gain on liabilities

A holding company has given a loan to its subsidiary company for the amount of Rs. 30,000,000. Advise the income tax implication from the point of the subsidiary company under the following circumstances.

1. The holding company decides to consider this loan outstanding as investment in shares and accordingly, the subsidiary company issues the shares to the extent of Rs. 30,000,000.
2. The holding company decides to write off this loan.
3. The holding company recovers a sum of Rs. 25,000,000 from the subsidiary company and decides to write off the balance amount of Rs. 5,000,000.

6.8. Exemptions

Capital gain exemptions mentioned in the Third Schedule are;

- A capital gain that does not exceed Rs 50,000 is exempt from capital gain tax and where the total gains made by the resident individual from the realization of investment assets in the year of assessment do not exceed Rs. 600,000. [This exemption is applying for the joint –owned property so that the exemption applies only if the total capital gain made by all the joint owners of the property does not exceed the Rs 50,000.]
- A capital gain arising for a resident individual on disposal of individual's principle place of residence is exempted provided it has been owned by the individual continuously for the three years before being realized and lived in by the individual for at least two of those three years (calculated on a daily basis)
- Gain made on realization of an asset consisting of shares quoted in any official list published by any stock exchange licensed by the Securities and Exchange Commission of Sri Lanka.

Capital Gain – Exemptions The capital gain arising from realization of land amount to Rs 1500,000/= during the year of assessment 2021/22. Land is owned by Mr. Amal, Mr. Kamal and Mr. Sumal equally. **Compute** the capital gain for Mr. Amal for the year of assessment 2021/22.

6.9. Capital Loss

As per Section 19(5) Capital loss cannot be set-off against any capital gain (nor deductible against other forms of taxable income).

6.10. 7.10. Administration Provisions

Filling of CGT

A person disposing of a capital asset should be required to file a CGT return within one month after the realization of the capital asset. The CGT tax is imposed on a transactional basis rather than periodic basis. Consequently, a separate return must be file in respect of each transaction. A person who fails to file tax return on or before the due date shall be liable to pay a penalty as per Section 178.

Ex: Mr X realized his land on 01.05.2020 and Mr X need to submit return on or before 01.06.2020.

Payment of CGT

The CGT payable by a person on the disposal of a capital asset should be made on the date of filling the tax payer's CGT return in respect of realization. Where the Commissioner General is satisfied that an investment asset has been realised in two or more parts then instalment payment can be paid and tax credit will be available.

Ex: Mr X realized his land on 01.05.2020 and Mr X need to submit return on or before 01.06.2020

CHAPTER REVIEW EXERCISES

1. ISL intends to sell a bare plot of land which has been recorded as an investment asset in the books of account for a consideration of Rs. 9,500,000 in the near future. This land was purchased at a cost of Rs. 3,670,000 five years ago and the market value of this land as at 30 September 2017 was Rs. 8,750,000. An advertisement has already been published to find a buyer to sell this land and the cost incurred on this was Rs. 82,000.

2. An individual has disposed a house (investment asset) on 30.01.2022 for a sum of Rs. 35,800,000. He has incurred the following expenses in relation to this property.
    i. Cost incurred by him in acquiring this house in 2010 was Rs. 18,900,000.
    ii. Stamp duty paid at the time of acquisition was Rs. 755,000.
    iii. Cost incurred in repair and improvement during the period of his ownership was Rs. 2,850,000.
    iv. Cost incurred in relation to advertisement made for the sale of property in January 2022 of Rs. 150,000.
    v. Commission paid to the broker who found the buyer of Rs. 567,000.

The market value of this property as at 30.09.2017 was Rs. 29,000,000. Calculate the gain from realisation of the asset.