

Chapter Review Exercises

Chartered Accountancy Strategic Level Corporate Taxation (TAX)

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- Section 4 of the IRA specifies that a resident is liable to pay income tax on its global income, whereas a non-resident is liable to pay income tax only on the profits and income arising in or is derived from a source in Sri Lanka.
- Section 69(4) of the IRA gives the criteria for a company to be recognized as a resident for income tax in Sri Lanka. Since Heera Ltd is a company incorporated in India, it does not satisfy the criteria set out in section 69(4) and therefore, it will be considered as a non-resident person for income tax in Sri Lanka. Therefore, it will only be liable to pay income tax in Sri Lanka on the income it derives from a source in Sri Lanka.
- Section 73 of the IRA lists the payments that are considered to have a source in Sri Lanka. And this includes “payments received in respect of activity conducted or a forbearance from conducting activity in Sri Lanka in relation to a non-resident person, to the extent attributable to a Sri Lankan permanent establishment...”
- Section 195 defines a “Sri Lankan permanent establishment” to mean ‘any business connection or fixed place of business through which the business of the enterprise is wholly or partly carried out, irrespective of the number of days of such business being carried out in Sri Lanka’.
- Since Heera Ltd is engaging in business activities through SEL, and since SEL has the capacity to conclude contracts on behalf of Heera, it will be considered as Heera having a Sri Lankan permanent establishment and it will be liable to income tax in Sri Lanka.
- Section 75 provides that where there is a double tax treaty between Sri Lanka and the country of residence of the non-resident person, then the provisions of the DTA will supersede the domestic law.
- Sri Lanka has entered into a double tax treaty with India and the provisions of the DTA will apply to Heera.
- Article 7 of the DTA specifies that profits of the enterprise will only be taxable in the other State if business is carried on in the other State through a permanent establishment situated in the other State. However, the profits that will be taxable will be limited to only so much of the profits that is attributable to that permanent establishment.
- Article 5 explains what is a permanent establishment and it includes, where an agent is acting on behalf of an enterprise in the other State, that enterprise is deemed to create a PE in the other State if such person has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise. Based on the facts, SEL has the authority to conclude contracts on behalf of Heera and therefore, Heera will be deemed to create a PE in Sri Lanka.
- Therefore, Heera will be liable to pay income tax in Sri Lanka.

(c)

- Section 85(1A) specifies that a person making a royalty payment with a source in Sri Lanka to a non-resident person, withholding tax must be deducted at the rate provided in the First schedule.
- The rate specified in the First schedule as withholding tax on Royalty is 14%.
- Since Sri Lanka has entered into a DTA with India, Article 12(2) of the DTA specifies that the tax on royalty paid to a person in the other contracting state should not exceed 10%.

- However, Article 12(4) specifies that where the beneficial owner of the royalties is carrying on business in that other State through a permanent establishment, then the royalty will be liable to income tax under Article 7 as business profits and Article 12 will not apply.
- Since Heera has a PE in Sri Lanka, the royalty income will not be subject to withholding tax and the royalty income will be liable to income tax in Sri Lanka as business income attributable to the PE in Sri Lanka.

(d)

- Section 69(1) of the IRA specifies the criteria to be satisfied where an individual is to be considered as a resident for income tax purposes. According to this section, an individual who is present in Sri Lanka during a 12 month period for more than 183 days in aggregate will be considered as a resident for income tax purposes and he will be liable to pay income tax on his global income.
 - Based on the facts provided, Mahesh is present in Sri Lanka for 195 days in aggregate and therefore, he will be considered as a resident for tax purposes in Sri Lanka.
 - Sri Lanka has entered into a double tax treaty with India and the DTA will apply in this case.
 - Article 15 of the DTA specifies that where a person receives remuneration for employment exercised in the other contracting State, such employee will be liable to tax in that other State where the 3 criteria specified in Article 15(2) are not satisfied.
 - Mahesh will be liable to pay income tax only in India, if all of the following 3 criteria are satisfied;
 - (a) the recipient is present in that other Contracting State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned ; and
 - (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other Contracting State ; and
 - (c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in that other Contracting State.
 - Based on the information provided, Mahesh is present in Sri Lanka for more than 183 days and his remuneration is borne by the PE in Sri Lanka. Therefore, he will be liable to pay income tax in Sri Lanka on his employment income derived from the services provided in Sri Lanka.
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- Mahesh is exercising his expertise on the technical aspects of diamond cutting machines and earns a profit of USD 5,000 on this transaction.
 - This is a single isolated transaction that he has done during his stay in Sri Lanka for 195 days.
 - Section 3 and 4 specifies that income tax should be paid on any business income earned by any person in Sri Lanka.
 - Section 195 defines “business” to include “a trade, profession, vocation or isolated arrangement with a business character however short the duration of the arrangement..”

- Therefore, since Mahesh bought the machine with a view to repair it and resell it, the transaction will be having a business character. And even isolated transactions are captured in the definition.
- Therefore, Mahesh will be liable to pay income tax on the profits he earned from this transaction.
- In the case of CIR v Livingstone, 3 people bought a cargo vessel with a view to converting it into a steam ship drifter and sell it. They conducted extensive repairs to bring the vessel into a marketable condition. It was held in this case that the transaction was an adventure in the nature of trade even though it was an isolated transaction, since they embarked on activities to make it marketable.
- Based on the facts in this case, Mahesh will be liable to pay income tax on the profits of USD 5,000.

05th January 2022

ABC (PVT) LTD

Address.....

Commissioner General of Inland Revenue,
Department of Inland Revenue,
Colombo.

Dear Sir,

APPEAL AGAINST THE ASSESSMENT ISSUED
YEAR OF ASSESSMENT 2020/21

We refer to the Notice of assessment issued and wish to lodge an appeal against the same. The grounds of appeal are as follows;

1. Entertainment allowance - Disallowed

The Company has paid an entertainment allowance to its employees which is a cash benefit which has been subject to withholding tax when making the payment to the respective employees. The amount of entertainment allowance paid has been subject to tax in the hands of the employees and the relevant tax deducted as withholding tax has been duly credited to the Commissioner General of Inland Revenue. Therefore, the company is entitled to deduct the entertainment allowance paid to the employees when computing its income tax liability for the year.

2. Tax has not been paid

The company has made all the installment tax payments on or before the due date. The company also claimed a tax credit of Rs. 450,000 which is withholding tax that has been

deducted on its interest income. The assessment has not considered the withholding tax credit due to the company when arriving at the balance tax payable.

3. Bad debt provision - Disallowed

We wish to point out that the amount of Rs. 2,300,000 is not a provision made by the company as bad debt, but it is a write off of bad debt. Section 24(6) provides that a person cannot disclaim the entitlement to receive an amount or write off a debt claim as bad unless the person has taken reasonable steps in pursuing payment and the person reasonably believes that the entitlement or debt claim will not be satisfied". We wish to emphasize that the company has taken all reasonable steps to recover the said amount and the company lawyer has now sent the debtors letters of demands requesting for the payment. However, we reasonably believe that the amount due will not be paid by the respective debtors. Therefore, the company is entitled to deduct this amount as bad debts written off under section 24(6).

Considering the above facts, we kindly request you to;

- Allow the deduction of Rs. 1,500,000 paid to employees as entertainment allowance
- Grant credit of Rs. 450,000 for the withholding tax deducted on the interest income earned by the company
- Allow the deduction of Rs. 2,300,000 as bad debt written off under section 24(6)
- Waive off the penalty in full since the company has paid taxes in full and annul the above notice of assessment issued to the Company.

Kindly acknowledge the receipt and be good enough to issue the acknowledgement.

Yours faithfully,

DIRECTOR

