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Specialised Business Undertakings

Chartered Accountancy
Strategic Level
Corporate Taxation (TAX)

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6. SPECIALISED BUSINESS UNDERTAKINGS

6.1. Company

6.1.1. Basis of liability

A company is liable, as in the case of every person, to income tax on its income for the year of assessment, other than as set out under item 6.1.3.

Definition

The IRA defines a company to mean the following;

"(a) means 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
(c) excludes a partnership or trust; and
(d) 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;"

6.1.2. Rules applicable to companies

1. Legally, a company is considered separate from that of its shareholders. The treatment for purposes of tax is in line with same and a company is liable to tax separate from its shareholders.
2. All business activities of a company shall be treated as conduced in the course of a single company business, unless different tax rates are applicable to the different activities and sources of income, in which case each such different activity and source shall be treated as distinct businesses and sources.
3. Other than if there is a special mention in the tax law, all arrangements between a company and its managers and shareholders are to be recognized.

6.1.3. Taxation of shareholders

The following transactions between a shareholder and a company would be subject to tax in the following manner;

(i) Dividends distributed by a resident company are to be taxed in the hands of the company's shareholders

(ii) Dividends distributed by a non-resident company are to be included in calculating the income of the shareholders.

(iii) Gains on the disposal of shares in a company shall be included in calculating the income of a shareholder.

6.2. Partnerships (Sec. 53-56)

6.2.1. Nature of a partnership

Partnership if a form of business organization which is defined in the UK Partnerships Act 1890 as "The relation which subsists between persons carrying on a business in common with a view to profit."

6.2.2. Advantages of a partnership form of association

A partnership provides a simple and convenient form of association, particularly for those with limited resources and skills who desire to set us a business.

It also affords an opportunity to a sole proprietor to expand and upgrade his activities by bringing in fresh capital and experienced management.

The partnership form is adopted by some professionals who practice jointly, especially since some of them cannot incorporate.

6.2.3. Evidence of Partnership

There are certain factors which point to the evidence of a partnership. This includes;

a. Relationship of agency
b. Community of profits and losses
c. Contribution of capital
d. Sharing of drawing on profits

A partnership agreement can be;

a. Written
b. Oral or
c. Implied by the conduct of partners

The question whether the relationship between two persons is that of partners, or of employer and employee, or principle and agent, is to determine on relevant documents and the circumstances of the case.

In the absence of other evidence, the mere fact that a person is remunerated by a share of the business profits is not sufficient to establish a partnership. *David vs. AG* (8 TC 341)

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6.2.4. New Partners

In terms of section 53(8) where there is a change of partners in a partnership and at least two of the existing partners continue, the partnership is treated as the same entity both before and after the change.

Generally, when new partners are added on, there is no cessation of a business. It is only the sale of a proportionate share of the business. The business goes on, on a continuous basis, with a structural change.

6.2.5. Definition of "partnership" for income tax (sec. 195)

A "partnership" is defined in Section 195 to mean "An association of two or more individuals or corporation carrying on business jointly for the purpose of making profits, irrespective of whether the association is recorded in writing."

6.2.6. Co-ownership (Sec. 29)

A co-ownership is not a partnership, although a co-owner may undertake a joint venture on the co-owned property. In terms of provisions in relation to co-ownership in the Inland Revenue Act, in determining a person's income from an investment that is jointly owned, income or expenses must be apportioned amongst owners in proportion to their respective interest in the investment.

Where the interest of joint owners cannot be ascertained, the income or expense should be equally divided.

6.2.7. Tax status of a Partnership

A partnership's income for a year of assessment is the partnership's income from its business or investment for that year of assessment.

A loss incurred by a partnership for the year of assessment shall be the partnership's loss from its business or investment for the year.

In terms of section 53(6) of the IRA, all business activities of a partnership are treated as conducted in the course of a single partnership business.

The law recognizes amounts derived and expenditure incurred in common by the partners as amounts derived or expenditure incurred by the partnership.

Assets owned and liabilities owed in common by the partnership are treated as assets owned and liabilities owed by the Partnership and are to be treated as follows;

a. Assets – considered acquired when the said asset is owned
b. Liabilities – considered incurred when there is a legal obligation to pay
c. Realised – when there is a cessation of ownership of liability

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A partnership is liable to pay income tax on its taxable income w.e.f. 01 st January 2020 at the following rates;

First Rs. 1,000,000	0%
Balance exceeding Rs. 1,000,000	6%

Where the partnership has any gains on the realization of an investment asset such gains will be taxed at the rate of 10%.

In all other cases, a partnership is deemed to have,

a. Distributed its taxable income to its partners
b. Distributed its tax credit to its partners

6.2.8. Business income of a partnership

Business income or loss of a partnership is the share of its divisible profit or divisible loss.

A partner's share refers to the partner's interest in any income of the partnership as stated in the partner's agreement.

Partnership income or loss allocated to partners is subject to the following;

a. It shall retain its character as to type and source
b. Shall be treated as an amount derived or expenditure incurred, respectively, by a partner at the end of the partnership's year of assessment, and
c. Shall be allocated to the partners proportionately to each partner's share, unless the Commissioner General by notice in writing and for good cause, directs otherwise.

6.2.9. Determination of divisible profits

The divisible profit of a partnership is computed in the same manner as the ascertainment of profit of a person in any business. Certain adjustments are however made as follows;

a. Interest on loans

Interest on loans are not considered as an expense of the partnership for tax purposes and are disregarded when determining divisible profit.

b. Payments for services provided by a partner

Payments in consideration for services provided by a partner, whether same be a salary of a service fee, are not considered a deduction when determining divisible profits.

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6.2.10. Gains on the sale of a partner's share

Gains derived on the disposal of shares in a partnership by a partner are considered income from business.

When determining costs of a partner's membership interest in a partnership, the following should also be considered in proportion to the partner's interest in shares, in addition to the cost involved in investment;

a. Divisible profits distributable to the partner; and
b. Exempt income of income on which final withholding tax has been paid

Distributions made by the partnership and domestic and excluded expenditure should be considered part of the consideration in addition to the sale proceeds received.

CHAPTER REVIEW EXERCISES

Question 1

"Pretty Woman" is a partnership business carried out by three friends namely, Meena, Neela and Leela. They operate a beauty salon as a core business activity. In addition, they also function as an educational institute that offers diploma courses in beauty culture.

When forming the partnership, they agreed on the following conditions:

- Profits and losses should be shared in the ratio of 2:2:1 among Meena, Neela, and Leela respectively.
- Meena and Neela are entitled to receive a salary of Rs. 2,000,000 and Rs. 1,000,000 per annum respectively.

Per the income statement of the partnership for the year ended 31 March 2021, net profit was Rs. 3,326,000. In arriving at this profit, the following expenses were deducted.

- Partners' salaries of Rs. 3,000,000.
- Neela's son, Anil who worked as the administration officer of the partnership was paid a monthly salary of Rs. 50,000.
- Leela had provided a loan of Rs. 1,000,000 to the partnership and interest was paid at the rate of 8% per annum.
- The salon was operated in a building owned by Neela, and she was paid a monthly rent of Rs. 100,000 by the partnership.

During the year, the partnership had received dividend out of profits of Rs. 172,000 from listed companies and it had been credited to the income statement.

Required:
(i)**Define** the term "partnership" per the Inland Revenue Act No. 24 of 2017.
(ii)**Assess** the income tax payable by the partnership and allocate the profits and tax credits among the partners for the year of assessment 2020/21.

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Question 2

PN Brothers is a partnership formed by two brothers, Praveen and Nissal. It engages in the business of wholesale and retail sale of stationery items. As per the partnership agreement, it was agreed to share profits and losses equally between Praveen and Nissal.

As per the financial statement for the year ended 31st March 2021, turnover and net profit of the partnership were Rs.54,350,000/- and Rs.12,100,000/- respectively.

(1) The following expenses have been deducted when arriving at the net profit:
Salaries paid to partners 2,640,000
Salaries to office staff 3,950,000
Depreciation on assets 190,000
(2) Praveen and Nissal draw monthly salary of Rs.120,000/- and Rs.100,000/- respectively for their involvement in the business.
(3) Capital allowance on assets for tax purposes for the year of assessment 2020/21 was Rs.175,000/-.

Calculate the following:

a) The partnership income for tax purpose for the year of assessment 2020/21.
b) The income tax payable by the partnership for the year of assessment 2020/21.
c) The share of partnership income of each partner for the year of assessment 2020/21.
d) The tax credit available to each partner for the year of assessment 2020/21.

6.3. Trusts (Sec 57-58)

6.3.1. Trust

A trust is formed when a person is generally a testator or settlor, conveys or vests by deed, property to the other called the trustee, in such a manner and circumstances so as to compel him to administer the property for the benefit of another called the beneficiary.

The law defines a "Trust" to mean " An arrangement under which a trustee holds assets." In terms of the tax law, an arrangement between a trust and its trustees or beneficiaries is recognized.

Trusts are generally created in terms of wills and family settlements or by charitable endowments. A trust can be effective during the lifetime of the testator or at his death. A trust has to be administered in accordance with the intentions of the testator. Such intentions are found in the Trust Deed or can be implied from the trust instrument.

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A trust is the legal owner of the property (other than as a bare agent or for an absolute entitled beneficiary) but it has to act within the authority of the trust instrument.

6.3.2. Trustee

A "trustee" is defined in the law to mean – an individual or body corporate holding assets of a fiduciary capacity for the benefit of identifiable persons or for the same object permitted by law and whether or not.

a) The assets are held alone or jointly by another individual or bodies corporate, or
b) The individual or body corporate is appointed or constitutes a trustee by personal acts, by will, by order or declaration of a Court or by operation of the law, and
c) Includes,
   i. An executor, administrator, tutor or curator
   ii. A liquidator, receiver, trustee in bankruptcy or judiciary manager
   iii. A person having the administration or control of assets subject to a usufruct or other limited interest
   iv. A person who manages the assets of an incapacitated individual
   v. A person who manages assets under a private foundation or other similar arrangement

Separate calculations of income shall be maintained for separate trusts regardless of whether they have the same trustees.

6.3.3. Tax status

6.3.3.1. Trust where beneficiaries are not presently entitled to income

The trust (other than that of an incapacitated person) is taxed as an entity. Amounts derived and expenditure incurred by a trust or a trustee other than as a bare agent or for an absolutely entitled beneficiary, shall be treated as derived or incurred by the trust and not any other person, regardless of whether or not the amount is derived or incurred on behalf of another person and whether or not any other person is entitled to such amount or income constituted by such an amount.

The taxable income of such trust, other than gains from realization of investment assets will be liable to tax at the rate of 18% w.e.f. 01st January 2020. Gains from realization of investment assets would be taxed at 10% in the hands of the trust.

6.3.3.2. Trust where beneficiaries are presently entitled to income

In such an instance the taxable income of the trust would be the income derived through trust properties excluding income attributable to beneficiaries who are presently entitled to the income of the trust.

A beneficiary of a trust is liable to income tax on income of the trust to which that beneficiary is presently entitled for the relevant year of assessment. A beneficiary is considered to be presently entitled to the income of a trust, if he has a vested and indefeasible interest in the income of the trust and an immediate right to demand payment of the income from the trustees of the trust.

The trust is not liable to tax on its income which the beneficiaries are presently entitled to, except for gains from the realization of investment assets, which will be subject to tax in the hands of the trust at the rate of 10%.

The income recognized by the beneficiary would be subject to the following;

a) Amounts derived and expenditure incurred by a trust or trustee shall be treated as derived and incurred by the beneficiaries and not the trust or the trustees or any other person.
b) Such amount shall retain its character as to type and source
c) Each amount shall be treated as an amount derived or expenditure incurred respectively by the beneficiary at the end of the year of assessment of the trust
d) Each amount shall be allocated to the beneficiaries proportionately to each beneficiary's share, unless the Commissioner General by notice in writing or for other good cause, directs otherwise in writing.
e) The tax paid by the trust and foreign income tax paid or treated as paid by the trust with respect to trust income, is to be allocated to the beneficiaries at the end of the year of assessment of the trust and is treated as derived by the beneficiaries in proportion to each beneficiary's share and treated as paid by them.

6.3.3.3. Taxation of distributions by a trust

A distribution by a resident trust is exempt in the hands of the trust beneficiaries. Distributions received from a non-resident trust are considered income in the hands of the beneficiaries of the trust other than those that represent an amount which has been distributed by a trust which has paid tax in Sri Lanka on the said income or has been subject to tax as income to a beneficiary who has indefeasible interest in the trust.

6.3.3.4. Disposal of interest in a trust

Gains on the disposal of any interest of a beneficiary in a trust are to be included as income of the beneficiary.

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Taxation of trusts

Miss Karuna and Miss Muditha are twin sisters and young beneficiaries to a non-revocable trust set up by their father, Mr Meththananda. The trust is to be managed by a professional trustee, Ms Upeksha, who is paid an annual fee out of the income of the trust. Under the trust deed, the trust assets comprise three large tracts of farm land which are rented out to farmers (thus deriving rental income). The lands are to be held and managed by the trustee for the benefit of the beneficiaries for the rest of their lives, the income and proceeds from which are to be used only for educational and health purposes. Each of Miss Karuna and Miss Muditha has the right to demand payment of up to LKR 1 million of rental income from the trust upon attaining 21 years of age. Miss Karuna and Miss Muditha will turn 21 years old on 1 July 2020. The trust has a year of assessment ending 31 March 2021. Total rental income of the trust was Rs. 4 million and the deductions for expenses of the trust including the annual fee paid to the trustee is Rs. 1 million.

Compute the income tax payable for the year of assessment 2020/21.

6.4. Unit Trusts (Sec.59)

6.4.1. Tax status – Unit trust not carrying on an eligible investment business

A unit trust or mutual fund that does not conduct any eligible investment business is deemed to be a company resident in Sri Lanka and the tax treatment in relation to companies in Sri Lanka would apply to the said trust.

The law defines "eligible investment business" to mean: "A business or investment comprising predominantly of owning investing or trading in,

a. Capital assets
b. Financial instruments or
c. Other similar assets

Where a unit trust is deemed to be a company, the following would also apply;

a. A unit of a unit trust or mutual fund is considered to be a share in a company
b. A unit holder of any unit trust or mutual fund is deemed to be a shareholder of the company
c. The income derived by or which arose or accrued to the benefit of the trustees of the unit trust or the custodian of any mutual fund from any property subject to that unit trust or mutual fund or from any business carried on by such trustees or

such custodian for and on behalf of that unit trust or mutual fund, is considered to be income of the company.

d. Any distribution in any manner whatsoever of the income of the unit trust or mutual fund to its unit holders is deemed to be dividends distributed to shareholders of that company
e. Paid up value of any unit trust or mutual fund shall be deemed to be the paid up value of shares of that company
f. Any sum paid by way of remuneration to the manager or the trustee of a unit trust or the manager or custodian of any mutual fund out of funds of the unit trust or mutual fund, shall be deemed to be an expense incurred by the company in the production of income and deductible for tax purposes.

The Ministry of Finance has issued an administrative directive where it has indicated that certain unit trusts would be taxed as pass through vehicles. By this directive, fixed income unit trusts, Government of Sri Lanka security funds and equity funds could achieve this status on meeting specified conditions.

6.4.2. Tax status – Unit trust carrying on an eligible investment business

According to the s.195 ***"eligible investment business" means*** *a business or investment comprising* ***predominately*** *of owning, investing or trading in –*

(a) capital assets;
(b) financial instruments; or
(c) other similar assets;

"*predominantly*" *means 80% or more, calculated based on gross income.*",

Unit trusts that conduct eligible investment business will be treated as "pass through vehicles" and tax will be payable by the unitholders rather than by the unit trust itself (see section 57(2)), with the exemption of the tax payable on gains from the realization of investment assets (which would be NIL for listed shares). This "pass through" treatment arises because unitholders have fixed entitlements to the income of the unit trust corresponding to their unitholding.

The income could be received as a distribution or redemption entitlement. Individual unit holders pay tax on their share of the income that they are legally entitled to from the unit trust, irrespective of how that entitlement arises (e.g. as pro rata entitlement or as an allocated redemption amount). The actual distribution (whether as part of a redemption payment or not) is already exempt to avoid double taxation as unitholders are already liable to tax on their share of the unit trust's income. If received as a redemption entitlement that portion which represents income of the trust will be treated as such under the IRA, with a corresponding reduction when calculating the gain or loss on the unit holding itself in order to also ensure there is no double taxation s.38(3).

Further, each amount of income to which a unit holder becomes entitled to (whether as part of a redemption payment or not) will be treated as follows under the s. 57(2):

- each amount derived by the trust or trustee (in such capacity) is treated as derived and incurred by the beneficiary (not the trust or trustee);
- each amount retains its character as to type and source;
- each amount is allocated proportionally to each beneficiary's share, including tax paid under the Act or foreign income tax paid or treated as paid by the trust with respect to the trust income allocated.

6.5. Charitable institutions

6.5.1. Definition of a "Charitable Institution"

A charitable institution is defined in section 195 of the Inland Revenue Act to mean:

- The trustee or the trustees of a trust or
- Corporation or
- Unincorporated body of persons

Established for a charitable purpose only or engaged solely in carrying out a charitable purpose.

A "charitable purpose" means a purpose for the benefit of the public or a section of the public, in or outside Sri Lanka, of any of the following categories;

a. Relief of poverty
b. The advancement of education or knowledge, other than by an institution established for business purposes or by any institution established under the Companies Act
c. Activities for the protection fo the environment or eco-friendly activities
d. The advancement or religion or maintenance of religious rights on the practice or the administration of a place of public worship
e. Any other purpose beneficial to the community not falling within any other above categories

Relief of poverty

Relief of poverty can take many forms. Gifts for the relief of poverty have always been held to be charitable even if there is kinship or a contract and whether they are made in cash or kind. They may be directed for some permanent ends such as maintenance of an organization doing poverty alleviation or the establishment of such projects as homes for the aged.

Generally speaking however such relief measures must be for the benefit of the community or a section or group of the community.

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Advancement of education or knowledge

Gifts for the advancement of education or knowledge must be of a kind that benefits a cross section of the community. This could be within a region or locality or for a particular profession. Education for an individual or descendants of a particular individual or individuals is not considered charitable.

It was held in the case of *Openheim v Tobacco Securities Trust* (1951 AC 297) that provision of education for the children of employees or ex-employees of a firm is not a charitable institution.

Advancement of religion

Religion is considered here in a broad sense without concern of particular creeds or tenets. It must however have an impact upon the public at large who must have access to its rites and practices or the places of its worship.

In the case of *CIT v Croos Raj Chandra* (3 CTC 226) it was held that the holding of mass for the benefit of particular individuals does not confer a benefit on a section of the public in the form of worshippers at the church during mass. Hence, its advancement could be considered a charitable purpose.

Any other charitable purpose

The wording "any other purpose beneficial or in the interest to mankind" appear to have a very broad sweep to include almost anything. But here again it is limited by the primary concept of its necessity to be of benefit to the public or any section of the public.

6.5.2. Scope of liability

A charitable institution would generally be liable to tax depending on its income sources and be taxable in terms of the provisions in the law relating to each of the said sources.

The taxable income of a charitable institution is liable to tax at the rate of 14%. Donations, offerings etc, received by a charitable institution are generally not liable to tax unless the institution falls within the scope of an NGO.

There is an exemption from income tax on the interest income of a charitable institution,

> "where it is proved to the satisfaction of the Commissioner-General that such interest is applied solely for the purpose of providing care to children, the elderly or the disabled in a home maintained by such charitable institution;"

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6.6. Non-Governmental Organisations (NGOs) (Sec. 68)

NGOs which comply with charitable requirements as provided in the preceding sections, would qualify as a charitable institution. NGOs at present, have to register with the Registrar of Companies. A sum of 3% of funds received by way of grants, donations, contributions, in any form, would be treated as income liable to tax (at the rate of 24%) on an NGO, which is in addition to the tax liability arising on taxable income on other sources of income (taxed at 24%).

6.6.1. Remission of Tax

Where an NGO is engaged,

a) Solely in rehabilitation, provision of infrastructure facilities and livelihood support to displaced persons in identified areas, or
b) Any humanitarian activity approved by the Minister factoring the nature and gravity of any disaster and the magnitude of relief required to be provided consequently, or
c) Where a charitable institution provides institutional care for the sick or the needy and the cost of provision of such care is borne by the charitable institution,

the Commissioner General may reduce or remove the tax payable.

6.7. Banking Institutions (Sec. 66)

6.7.1. Definition of "Banking business"

The law does not define the term "banking business". The Banking Act, No. 30 of 1988 defines the term to mean: "The business of receiving funds from the public through the acceptance of money deposits payable upon demand by cheque, draft, order or otherwise, and the use of such funds either in whole or in part of advances, investments or any other operation either authorized by the law or by customary banking practices."

Person's activities in conducting a banking business is treated as a **business separate from any other activity** of the person and the **income or loss** from such business for a year of assessment should be **calculated separately** (S. 66).

"Banking business" means the **banking business** of a Financial Institution. {S.66 (3)}.
As per Section 195 of the Act,

"Financial Institution" means –
(a) any company or body of persons carrying on **banking business** and includes a licensed specialized bank, within the meaning of the Banking Act, No.30 of 1988;

(b) a non-banking financial institution regulated in the same way **as a bank** in paragraph(a); or
(c) any other category of person as may be prescribed.

Either section S.66(3) or 195 of the Act, has not defined the “banking business. “But the above two sections together are meant that provisions in the Act in relation to the banking business are applicable only on banking business of a financial institution. That means any activity of a financial institution does not falls within meaning of the “banking business”. Further, if a person carries on banking business and at the same time any other business as well, as per section 66, profit and income from banking business should be calculated separately and so, such person become a financial institution only in respect of banking business.

6.7.2. Deductibility of provisioning

A person carrying on a banking business must maintain accounts specific to the banking activity and if such person carries on any other activity, the accounts of the latter must be maintained separately.

As per the section 24(4), a person can deduct bad debt in calculating person’s income at the time of write off such debt if such amount has been included in person’s income calculated on accrual basis for any year of assessment. But, this section is subject to section 66 of the Act.

The Section 66 is applicable on persons conducting banking business. It says that if a person conducting **banking business** makes specific provision for a debt claim in accordance with the directives made by Central Bank of Sri Lanka, a portion specified by Commissioner General from such specific provision can be deductible in calculating the profit from banking business.

Accordingly, the link given by section 24(4) to section 66 implies following matters in deducting specific provision for debt claim in respect of banking business.

1. The specific provision will consider the amounts which has not included in person’s income calculated on accrual basis. That means person conducting banking business can deduct capital portion of the loan even if it is not included in person’s income.

   It should also be mentioned here that specific provision for a debt claim in accordance with the directives made by Central Bank of Sri Lanka is made only on capital portion of the debt claim.

2. However, direct bad debt writes off (not from the provision for bad debt) should be considered under sections 17, 26 and 39 (d).

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The Commissioner General is empowered to specify the extent to which that provision would be deducted in accordance with such directive. The Commissioner General of Inland Revenue, by Gazette Extraordinary No. 2064/51 dated 1st April 2018, has issued a directive specifying the following;

Specific provision for a debt claim in accordance with the relevant directives made by the Central Bank of Sri Lanka is deductible when determining tax profits, except the provisioning relating to the following;

i. Provision made in respect of potential risk of credit facilities in accordance with the relative directive made by the Central Bank
ii. Provision made in respect of pawn debtors in the business of pawn brokering carried on by a financial institution in accordance with the directive issued by the Central Bank.
iii. Provision made in respect of debt claim extended to an associated person
iv. Provision made in respect of a debt claim given to a person outside Sri Lanka.

6.7.3. Foreign Currency and Financial Instruments (Sec. 26)

Amount to be included and deducted in calculating business and investment income (Sec. 26(1))

Subject to subsections (4) and (5), this section shall apply to a person who is a financial institution where, under the provisions in Division II or IV of Chapter II, that person shall include an amount or may deduct an amount in relation to a financial instrument in calculating income from a business or investment.

The phrase "financial instrument" is defined in section 198.

In terms of Section 26(2), the time at which the amount is to be included or deducted shall be determined in accordance with generally accepted accounting principles. Those principles also determine to whom the amount shall be allocated, its quantum and its character.

In particular, generally accepted accounting principles apply even if they require the inclusion or deduction of an amount on a fair value accounting (mark-to-market) basis irrespective of –

(a) the other provisions of this Division;
(b) whether or not the amounts have yet been derived, incurred or realised; and
(c) whether or not the amounts are of a capital or revenue nature.

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Amount included and amount deducted with the written approval of the Commissioner General (Sec. 26(4))

With the prior written approval of the Commissioner General a person may include an amount or deduct an amount in relation to a financial instrument in calculating income from a business or investment –

a) when realised;
b) using a specified treatment relating to the character and timing of the amount, including where the financial instrument has been entered into for hedging purposes; and
c) where the amount is in a currency other than Sri Lankan Rupees, using a specified translation method such as requiring that the amount must be translated to Sri Lankan Rupees at the exchange rate applying between the foreign currency and Sri Lankan Rupees on the date the amount is taken into account for the purposes of this Act.

The Commissioner General may specify the extent to which this section applies to another person or class of persons.

In the absence of an applicable specification by the Commissioner General under subsection (5), an amount taken into account under this Act shall be expressed in Sri Lankan Rupees and, if an amount is in a currency other than Sri Lankan Rupees, the amount shall be translated to Sri Lankan Rupees at the Central Bank of Sri Lanka exchange rate applying between the foreign currency and Sri Lankan Rupees on the date the amount is taken into account for the purposes of this Act.

6.7.4. Taxation of other financial transactions

I. Mortgage or Other Security over an Asset (Sec. 49(1))

Providing loans on mortgage bonds is one of the normal banking business transactions. Such loans are considered as securitized loans. So, tax treatment applies to loans is similarly applicable on such securitized loans also.

Realization of Assets
As per the section 49(1), where a person (debtor) grants a mortgage on an asset to secure a debt owed to another person (Bank), following tax treatment should be applied.
(a) The debtor shall not be treated as realization the asset mortgaged and shall be treated as still owing the asset. It only a liability for the debtor.

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(b) For the Bank, it should not be treated as acquiring the asset but shall be treated as owing a secured debt.

Accordingly, no gain or loss from realization of assets should be calculated at the time of entering in to a mortgaged bond.

II. Finance Leases and Instalment Sale Agreements

Application of Section 31

The Section 31 deals with the tax treatment on payments under instalment sale and finance lease. It treats instalment sales and finance lease as sales with debt financing. Therefore, a rental under such arrangements is characterized as payment of interest and repayment of capital under a blended loan using interest compounded six-monthly or such other period as the Commissioner General may specify.

Accordingly, the following formula should be used for the calculation of interest component. However, considering the industry practice, the Commissioner General may specify to compound interest annually.

As per the section 31, interest component is a business receipt for lessor or seller as the case may be. The remaining part is a capital recovery which reduces the debt claim against the lessee or purchaser. The receipt of last instalments will cause the disposal of this debt claim for no gain or loss as the total of the capital recoveries is equal to the amount of debt claim.

In the case of lessee or buyer, payment of interest may be a tax deduction subject to the conditions imposed by section 12 and 18. Further, the payer has the liability to deduct withholding on such interest payment as relevant.

The capital portion of the payments constitutes a cost on repayment of the debt liability which was incurred to acquire an asset. So, such repayment becomes a capital nature expense which is not deductible under section 11(2).

The payment of last instalment will cause the disposal of this debt liability for no gain or loss as the total of the capital repayments is equal to the amount of debt liability. The meanings of blended loan, finance lease, instalment sale and lease term are given in section 31(6).

The "finance lease" is defined in section 31 of the IRA to be a lease where;

a) The lease agreement provides for transfer of ownership following the end of the lease term or the lessee has the option to acquire the asset after the expiry of the lease term for a fixed or pre-proposed price

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b) The lease term exceeds 75% of the useful life of the asset
c) The estimated market value of the asset after the expiry of the lease term is less than 20% of its market value at the start of the lease
d) In the case of a lease that commences before the last 25% of the useful life of the asset, the present value of the minimum lease payment equals or exceeds 90% of the market value of the asset at the start of the lease term; or
e) The leased asset is custom-made for the lessee and at the expiry of the lease term the asset will not be of practical use to any person other than the lessee.

Application of Section 49

Leasing of an Asset under a Finance Lease (Sec. 49(2))

As per the section 49(2), where an asset is leased under a finance lease, the lessor shall be treated as transferring ownership of the asset to the lessee at the time of entering into the lease agreement. Hence, lessee is deemed to have acquired the asset at the beginning of the lease agreement.

Further, as per the Section 49(3)(b), the lessee is deemed to have acquired the asset at market value. If so, the market value of the asset should consist of capital portion of the lease loan and any other payment made by the lessee to the lessor (other than the interest portion of the lease loan) or any other seller in respect of such acquired asset. The market value of an asset should be applied on any buyer alike including a lessee. As the ownership of the asset is deemed to be vested with the lessee, he can claim, subject to the other conditions specified in section 16, depreciation allowance on market value of the asset (depreciation allowance should not limit on the capital portion on the lease loan).

In the case of lessor, in terms of the section 49(3) says that he is treated as deriving an amount equal to the market value immediately before the transfer of the leased asset. Deriving an amount equal to the market value is realistic with regard to a lessor who is required to declare such market value as business receipt under section 6(2)(b) and therefore, eligible to claim allowance under section 13 of the Act. The tax treatment on such type of lessor is equal to the tax treatment on instalment sale which will be discussed further under the heading of instalment sale.

Further, section 49(3) is realistic in case of a lessor who is providing a lease loan covering the full market value of the asset. In such a situation, a lessor pays a market value of the asset to the asset selling person on behalf of the lessee. The asset selling company transfers the ownership of asset to the lessor. The lessor in turn provides a loan under finance lease to the lessee keeping such asset as a security. Hence, even section 49(3) apply in this situation on the lessor, no gain or loss is realized in the hands of lessor as market value of asset is equal to the cost of the asset.

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But, the section 49(3) does not apply to a lessor who is providing a lease loan covering a part of the market value of the asset. In such a situation, the other part of the market value of the asset is paid by the lessee to the asset selling company directly. However, ownership of asset is transferred to the lessor by the asset selling company as an industry practice.

Under section 49(2), such ownership is treated as transferred to the lessee. However, in respect of such transfer, lessor shall not be treated as deriving an amount equal to the market value immediately before transfer as lessor has paid only part of the market value to the asset selling company on the requirement of the lessee. As such it is not realistic to compute gain or loss for the lessor at the time of the deemed transfer as per section 49.

The section 49 (4) is applied where a lessee under a finance returns the asset to the lessor before ownership passes to the lessee at the end of the lease agreement with the payment of last rental. In such an event, lessee is treated as transferring the ownership of asset back to the lessor. Then, above tax treatment under section 31 and 49 should be adjusted accordingly.

III. Transfer of an Asset under an Installment Sale or Finance Lease (Sec. 49(3))

Where a person transfers an asset under an installment sale or, under a finance lease under section 49(2)-

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 expenditure of the amount referred to in paragraph (a) in acquiring the asset.

IV. Returning of Asset by Lessee under a Finance Lease (Sec. 49(4))

Where a lessee under a finance lease returns the asset to the lessor before ownership passes to the lessee (except the transaction referred to in section 49 (2)), the lessee shall be treated as transferring ownership of the asset back to the lessor.

V. Payments under a Finance Leasing, an Installment Sale or Annuity (Sec. 31)

Payments made by a person under a finance lease or in acquiring an asset under an installment sale shall be treated as interest and a repayment of capital under a loan made by the lessor or seller to the lessee or buyer.

Payments made to a person under an annuity shall be treated as interest and a repayment of capital under a loan made by the person to the payer of the annuity.

The interest and repayment of capital under as mentioned above shall be calculated as if the loan were a blended loan with interest compounded six-monthly or such other period as the Commissioner General may specify

As per the Gazette Notification No. 2064/56 dated 01.04.2018, Commissioner General considered any other period which is considered by the general accepted accounting principles.

For the purposes of this section –

***"annuity" does not include** an amount payable –*

(a) under an order of court by way of payment of alimony or maintenance; or
(b) to a spouse under a duly executed deed of separation;

***"blended loan" means** a loan –*

(a) *under which payments by the borrower represent in part a payment of interest and in part a repayment of capital;*
(b) *where the interest part is calculated on capital outstanding at the time of each payment; and*
(c) *where the rate of interest is uniform over the term of the loan;*

***"finance lease" means** a lease where –*

i. the lease agreement provides for transfer of ownership following the end of the lease term or the lessee has an option to acquire the asset after expiry of the lease term for a fixed or presupposed price;
ii. the lease term exceeds seventy five per cent of the useful life of the asset;
iii. the estimated market value of the asset after expiry of the lease term is less than twenty per cent of its market value at the start of the lease;
iv. in the case of a lease that commences before the last twenty five percent of the useful life of the asset, the present value of the minimum lease payments equals or exceeds ninety per cent of the market value of the asset at the start of the lease term; or
v. the asset is custom-made for the lessee and after expiry of the lease term the asset will not be of practical use to any person other than the lessee;

***"installment sale" excludes** a sale that provides for commercial periodic interest payable on sales proceeds outstanding; and*

***"lease term" includes** an additional period for which the lessee has an option to renew a lease.*

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VI. Islamic Financial Transactions (Sec. 32)

Income arising from any Islamic financial transaction shall be subject to tax in a similar manner as equivalent in substance to non-Islamic financial transactions.

VII. Long term contracts (Sec. 25)

Income and expenditure that relate to a long term contract are to be recognized on the basis of the percentage of the contract completed during each year of assessment. The percentage of the work completed would be determined by dividing total costs incurred on the contract by the estimated total contract expenditure. For purpose of the law, a long term contract is defined to mean a contract,

a) For manufacture, installation or construction, or in relation to each the performance of related services, and
b) Which is not completed within 12 months of the date on which work under the contract commences

The profit or loss from long term contract for a year of assessment is determined by considering amounts required as above to be included under "income" and offsetting deduction under the contract for that year.

VIII. Loss set off

Where a long term contract is completed and the person has unrelieved losses attributable to that contract in the year of assessment in which the contract ended, the Commissioner General of Inland Revenue may allow the said losses to be carried back and be treated as an unrelieved loss for an earlier year of assessment. The loss carried back is limited to the profit from the said contract.

IX. Foreign currency adjustments arising to a financial institution (Sec. 26)

A financial institution is permitted to account for in foreign currency, losses arising on a financial instrument, whilst it is required to account for and consider any gain as business or investment income.

The times at which the adjustment has to be included or deducted is determined in keeping with generally accepted accounting principles. These said principles also determine as to who derived the amount allocated, its quantum and its character.

Generally accepted accounting principles would apply even if same requires as inclusion or deduction of a fair value accounting adjustment, irrespective of,

a) Any other provision in this chapter
b) Whether or not the amount has been derived, incurred or realized
c) Whether or not the amounts are of a revenue or capital nature

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There is provision for an institution to seek to consider an exchange gain or loss as detailed below, provided the said institution receives written approval from the Commissioner General of Inland Revenue.

a) Account for same when realized
b) Using specified treatment relating to the character and timing of the gain or loss, including instances where the financial instrument has been entered into for hedging purposes, and
c) The usage of specified transaction method where conversion would be on the date a sum is taken into the financial statement.

X. Foreign currency adjustments arising to a person other than a financial institution

The Commissioner General of Inland Revenue is empowered to specify provisions that relate to the accounting of a foreign currency exchange gain or loss.

In the absence of any directive issued, where a transaction has been entered into in a currency other than Sri Lanka Rupees, there is provision in the law for such sum to be translated into Sri Lanka Rupees at the Central Bank exchange rate applicable to the said currency on the date the amount is taken into account for purposes of the tax law.

XI. Quantification of income and expenditure (Sec. 27)

The quantification of income or expenditure should be specified by the Commissioner General of Inland Revenue, or in the absence of such a directive, on market value.

Market value shall be determined on the arm's length standard related to associated persons, but int eh case of an asset, where there is a restriction in the transfer of asset or where the asset is not otherwise convertible into the payment of money, disregarding such restriction or non-convertibility.

XII. Re-identification of payer and payee (Sec. 28)

Section 28 empowers the tax administrator to treat a person diverting a payment as the payee or the payer of the payment. Accordingly, where the Commissioner General of Inland Revenue is of the view that a person may indirectly benefit from a payment or direct who is to be the payee of a payment and the payer intends the payment to benefit the person, he may, by notice in writing, serve on the payer, and

a) Treat a person as the payee of the payment
b) Treat a person as the payer of the payment or
c) Treat the person as the payee of the payment, and as making an equal payment to the person who would be considered the payee of the payment

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The intention of the payer of the payment includes an intention of an associate of the payer on a third person under an arrangement with the payer or an associate of the payer.

XIII. Compensation and recovery payments (Sec. 30)

Where a person or an associate of a person derives an amount which compensates for, or represents a recovery of,

a) Income which the person expects or is expected to derive; or
b) A loss or an amount to be deducted in calculating income which the person has incurred or which the person expects or is expected to incur

The compensation amount shall be included in calculating the income of the person and takes its character from the amount compensated for.

6.8. Insurance (Sec. 67)

6.8.1. Life Insurance

Determination of profits from business

Profits from business of a Life insurance company are determined on the aggregate of the following;

= Transfers from policy holder fund to shareholders as certified by the appointed actuary

Plus

Investment income of the shareholder fund

Less

Expenses incurred in the production of such income.

Losses available to the company can be claimed as a deductible cost when determining profits as above.

Where the insurance company has issued participatory policies and if surplus is distributed to a Life Insurance policy holder under the said policies, same is also deemed to be profits from business of the insurance company.

Temporary Concession (Sixth Schedule)

The portion of the gains and profits of any insurer engaged in the business of life insurance that is deemed as income of the life insurer under section 67 (2) shall be taxed at the rate of fourteen percent for three years of assessment after the commencement of the Act.

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6.8.2. General Insurance business of a non-resident person

The profit and income of non-resident company from the business of insurance, other than Life insurance, is to be ascertained as follows;

= Gross premiums from insurance business in Sri Lanka

Less

Reinsurance premium, net movement in un-expired reserves

Less

Actual losses net of reinsurance recoveries, agency expenses in Sri Lanka and a fair portion of expenses of head office

There is however, provision in the Act where profits cannot be ascertained in the manner above due to a lack of information or details, the Commissioner General of Inland Revenue is empowered to permit such company to determine profits by allocating profits of the entire company in proportion to its premiums received from Sri Lanka vis-à-vis the total premiums of the company.

6.9. Petroleum operations (Sec. 65)

6.9.1. Residency of a foreign contractor or sub-contractor

Any individual or entity who or which has entered into an agreement as a contractor or sub-contractor under the Petroleum Resources Act No. 26 of 2003, is deemed to be a resident in Sri Lanka for the term of the contract or sub-contract.

6.9.2. Determining profits

Income and gains from the business of petroleum exploitation under any petroleum resource agreement, is to be determined subject to the following;

a) Sales to be determined in compliance with accepted commercial practices and be subject to specific provisions and in the petroleum resource agreement entered into under the Petroleum Resources Act.

The undertaking, in addition to what is permitted to be claimed as deductions in the Inland Revenue Act, would qualify to claim the following when determining profits;

a) Payments made to a service sub-contractor for conducting petroleum operations
b) Costs relating to acquisition of plant, machinery and equipment used for the recovery of petroleum resources be permitted as a deduction instead of capital allowances provided under section 16 of the Act.
c) Interest expenses
d) Royalty paid to petroleum resources recovered under any petroleum resource agreement

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e) All expenses on the development and production of petroleum including capital expenses, where same has not been claimed previously
f) In the first year of production, all costs incurred by a contractor in exploration for unsuccessful wells in exploration blocks under any petroleum resource agreement, up to and including such first year of production
g) Any costs incurred by any contractor in the exploration for unsuccessful wells in exploration blocks under any petroleum resource agreement in any year of assessment after the first commercial production
h) Where a person has claimed 100% deduction on capital assets, any sales proceeds received on the realization of such assets would be considered a receipt from business and liable to tax.

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