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Deductions

Chartered Accountancy
Strategic Level
Corporate Taxation (TAX)

Dinusha Rajapaksha
ACA, CTA, Attorney at Law, LL.B Hons.

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JMC Jayasekera Management Centre (Pvt) Ltd
Pioneers in Professional Education
65/2A, Chittampalam Gardiner Mawatha, Colombo 02 | T: +94 112 430451 | E: info@jmc.lk | F: +94 115 377917

3. DEDUCTIONS WHEN COMPUTING THE ASSESSABLE INCOME

Division IV of the IRA deals with deductions that can be made is computing the assessable income. The deductions under the IRA mainly fall into 3 categories;

1. General deductions (section 10)
2. Main Deduction (section11)
3. Other deductions including specific deductions (section 12-19)

3.1. Main deduction rule

Section 11 is the main deduction rule which states;

(1) In calculating a person's income from a business or investment for a year of assessment, expenses to the extent they are incurred during the year by the person and in the production of income from the business or investment, shall be deducted.

(2) No deduction shall be allowed under subsection (1) for an expense of a capital nature.

(3) In this section, "expense of a capital nature" includes an expense that secures a benefit capable of lasting longer than twelve months.

(4) For the purpose of this section, cost of funds of the financial institution incurred on the loans provided for new businesses commenced on or after April 1, 2021 by any individual after successful completion of vocational education from any Vocational Education Institution which is standardized under Technical and Vocational Education and Training concept (TVET concept) and regulated by the Tertiary and Vocational Education Commission, shall be deemed to be incurred in the production of income of such financial institution."

Based on the above section, expenses of the business or investment can be deducted in ascertaining the income from business or investment.

The salient features in the Main deduction rule are;

1. Expenses must be incurred in the "production of income"
2. Expenses of a capital nature are not allowed to be deducted
3. "Actual cost" is eligible for deduction
4. The expenses can be deducted to the extent that they are incurred.
5. The section is residual in nature

3.1.1. Expenses must be incurred in the "production of income"

This means that the expense has to be incurred in the production of income from business or investment. Production of income generally refers to the intention to make a profit or gain. It does not necessarily mean that the business or investment should actually be profitable, but rather than the expenses are incurred as part of the activity that is intended to make the profit or gain. It is because of this reason, that start-up costs of a business are allowed as a deduction under section 11.

This was emphasized in by Lord Davy in the case of *Strong v Woodfield* (5 TC 215) as follows;

"It is not enough that the disbursement is made in the course of, or arise out of, or is connected with the trade or made out of the profits of the trade, it must be made for the purpose of earning the profits."

In the case of *Prince v Mapp* (46 TC 169) a dance musician claimed the expenses of an operation on the finger on the ground that it was necessary to continue his professional playing. It was held that it was not deductible.

The following case law is useful in identifying whether an expense is incurred in the production of income;

- *Hayley and Co. Ltd v The Commissioner of Inland Revenue* CTC – Volume III
- *Commissioner of Inland Revenue v A.W. Davith Appuhamy* - CTC – Volume III
- *Strong v Woodifield* - 05 TC 215
- *Rajapakse v Commissioner of Income Tax* - CTC – Volume I

3.1.2. Expenses of a capital nature are not allowed to be deducted

Under section 11(2) expenses of a capital nature are not allowed to be deducted. Section 11(3) defines what will be treated as a capital nature expenses which are expenses that secure a benefit of more than twelve months. However, this does not necessarily mean that an expense which secures a benefit lasting twelve months or less is revenue nature and vice versa.

Capital nature expenses
State whether the following expenses are of capital nature under the Inland Revenue Act.
1. Legal fees to purchase a land
2. Cost of construction of boundary wall in the existing factory
3. Cost of advertisement
4. Cost of machinery
5. Cost of repair
6. Share issue expenses

In determining whether such an expense is revenue or capital in nature, the various tests are provided in case law, such as the fixed or circulating asset test, enduring benefit test and once-and-for all test. The case law relating to these tests are given below;

- *Vallambrosa Rubber Co. Ltd. v Farmer* - 05 TC 529
- *Hancock v General Reversionary & Investment Co. Ltd.* - 07 TC 358
- *Artherton v British Insulated & Helsby Cables Ltd* - 10 TC 155
- *Theobald v Commissioner of Income Tax* - TC – Volume I
- *Associated Portland Cement Manufacturing Co. v Kerr* - 27 TC 103
- *Mitchell v Noble* - 11 TC 372
- *Haughton Tea Company Limited v Commissioner of Income Tax* - CTC – Volume I
- *Law Shipping Co Ltd v CIR* - 12 TC 621
- *Odeon Associated Theatres Ltd v Jones* - 48 TC 257
- *The National Mutual Life Association of Australia Ltd. V Commissioner of Income Tax* - CTC – Volume I

3.1.3. "Actual cost" is eligible for deduction

According to section 11, only "actual costs" are eligible for deduction. Therefore, this specifically prohibits the deduction of "notional" costs, such as those put to a reserve or provision account. This is confirmed by section 10(1)(b)(viii) as well.

3.1.4. The expenses can be deducted to the extent that they are incurred.

This means that the expenses are only allowed to the extent that they are incurred. This indicates that where there are expenses that are relating to several sources, such expenses need to be allocated to the respective profit generating activity separately.

Expenses are incurred

Identify whether the following items are deductible for the year of assessment 2020/2021.

1. Audit fee payable for the year ended 31.03.2021 is paid only in July 2021.
2. Salaries for the month of March 2021 paid on 9th April 2021
3. Prepayment made for insurance in March 2021 for the period relevant to 2021/2022.

3.1.5. The section is residual in nature

Section 11 is residual in nature. Therefore, if another provision in the IRA denies a deduction, then section 11 will not permit such deduction. This is because of section 10(4) which specifies;

(4) Where more than one deduction applies, the most specific deduction shall be applied even if that results in the denial of a deduction.

Specially sections 12-19 of the IRA are considered as specific deductions, and accordingly, if an expense is of a particular kind that is dealt with in one of those sections, then the more specific provision must be applied. In such circumstances, section 11 has no application and so becomes "residual" in nature.

Section 11 – Main deduction rule

1. ABC Company has acquired a machine for its manufacturing business. The purchase of this machine has been done by way of obtaining a bank loan.

   Discuss whether the interest payable on such bank loan can be deducted when computing the tax liability.

2. PQR Transport Company is carrying on the business of hiring vehicles. The cost of repairs incurred in repairing the vehicles is Rs. 1.2 Mn.

   Discuss whether the repair expenses can be deducted in full when computing the tax liability.

3.2. General deductions

Section 10 provides the general deduction rules when calculating the taxable income of a person. There are 5 main rules that are specified;

1. No deduction shall be made in calculating a person's income from employment.
2. Specified deductions as listed in section 10(1)(b) are not allowed as a deduction.
3. Where there is an obligation to withhold tax when making a payment, such expense will not be allowed as a deduction until the tax is withheld and paid to the CGIR
4. No deduction shall be allowed except as expressly permitted by the IRA
5. Where there are more than one deduction applies, the most specific deduction shall be applied even if it results in the denial of a deduction.

3.2.1. Deduction which are specifically prohibited (section 10(1)(b))

The following expenses have been specifically prohibited from being deducted.

1. domestic expenses
2. tax payable under this Act;
3. interest, penalties and fines payable to a government or a political subdivision of a government of any country for breach of any written law;
4. expenditure to the extent incurred by a person in deriving exempt amounts or final withholding payments;
5. retirement contributions, unless they are included in calculating the income of an employee or consist of a contribution by an employer to a pension, provident, gratuity or savings fund or a savings society, which is approved by the Commissioner-General subject to any specified conditions;
6. dividends of a company;
7. outlays or expenses for entertainment; [Section 195 defines ""entertainment" means the provision to any person of food, beverages, tobacco, accommodation, amusement, recreation or hospitality of any kind;]
8. an amount that a person has transferred, in his financial accounts, to a reserve or provision for expenditures or losses not yet incurred but expected to be incurred in a future year of assessment;
9. amounts incurred on lotteries, betting or gambling, other than amounts incurred from conducting a business of lotteries, betting or gambling; or

10. taxes or other levies specified by the Commissioner- General. [The CGIR by Gazette No. 2064/54 dated 1st April 2018, has specified the taxes as prescribed taxes.]

Domestic Expenses

Section 197 defines "domestic expenses";

(1) Where an individual incurs expenditure in respect of himself, the expenditure shall be domestic expenditure to the extent that it is incurred –
  - (a) in maintaining the individual, including in providing shelter as well as meals, refreshment, entertainment or other leisure activities;
  - (b) in the individual commuting from home;
  - (c) in acquiring clothing, including shoes, for the individual, other than clothing that is not suitable for wearing outside of work;
  - (d) in educating the individual, other than education that is directly relevant to a business conducted by the individual and that does not lead to a degree or diploma; or
  - (e) in paying any personal debts, including credit card debts, of the individual.

The above expenses are mainly expenses incurred by a self employed person on his/her own behalf. Therefore these expenses cannot be deducted. However, certain expenses contain a limited exception;

1. Cost of clothing unless it is unsuitable to wear outside of work. Therefore protective clothing like the cloak worn by medical practitioners can be deducted. Similarly, the cost of clothing that forms part of a service provided, such as the costumes worn by performers can be deducted. It however, prohibits the deduction of expenses incurred on clothes that can be worn outside of work, for example suits worn by lawyers.
2. There is a prohibition on deducting expenses incurred by the individual in educating himself. But this does not prohibit the expenses made for the education that is directly relevant to business conducted by the individual and that does not lead to a degree or diploma. For example, the training taken by professionals to keep up to date with the practices that are relevant to the business is not prohibited. Therefore the cost of a training course offered to lawyers on recent changes in the law is deductible. However, the cost of a course to the same person on cooking is not deductible. Also if the education is part of a course leading to a degree or diploma then such expenses are denied.

Where another person incurs the expenses

Section 197(2) provides;

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

(a) the payment or benefit shall be included in calculating the income of the individual;

(b) the individual provides consideration of an equal market value for the payment or benefit; or

(c) the amount of the expenditure is so small as to make it unreasonable or administratively impracticable to account for it.

These are expenses incurred by a person on behalf of an individual's benefit. The benefits so provides, constitutes a payments and therefore becomes an expense incurred by such person.

Section 197 – Domestic expenses incurred by another person

1. Company ABC employs Mr. Fernando. It provides Mr. Fernando with private use of a company car, also the meals which are provided to all employees.

   Determine whether the expenses incurred in relation to the car and the meals are deductible when computing the tax liability of Company ABC.

2. NiceMeals is a restaurant run by Mr. Perera. He regularly permits members of his family to dine free of charge with his paying customers.

   Determine whether the expenses incurred in relation to the meals provided free of charge can be deducted when computing the tax liability.

Interest incurred on domestic expenses

Section 197(3) provides;

(3) Expenditure referred to in subsections (1) and (2) shall include interest incurred with respect to money borrowed that is used in a manner referred to in those subsections.

Therefore, any interest relating to domestic expenses will also be denied as a deduction.

Taxes or other levies specified by the Commissioner- General

The CGIR by gazette No. 2064/54 dated 1st April 2018, has listed the following taxes as prescribed taxes, which are not allowed as a deduction;

1. income tax, or super tax or surtax or any other tax of a similar character in any country with which an agreement made by the Government of Sri Lanka for

the avoidance of double taxation is in force (other than the excess of any such income tax, or super tax or surtax or any other tax of a similar character over such maximum amount of the credit in respect of Sri Lanka income tax as is allowed by subsection (1) of section 81); or

2. any Economic Service Charge levied under Economic Service Charge Act, No. 13 of 2006; or
3. any Value Added Tax on Financial Services levied under Chapter IIIA of the Value Added Tax Act, No. 14 of 2002 and any Nation Building Tax on Financial Services levied within the provisions of the Nation Building Tax Act, No. 9 of 2009; or
4. any Crop Insurance Levy levied under section 14 of PART IV of the Finance Act, No. 12 of 2013; or
5. super gain tax, Bars and Taverns Levy, Casino Industry Levy, Mobile Telephone Operator Levy, Satellite Location Levy, Dedicated Sports Channel Levy and Mansion Tax imposed and levied under the provisions of the Finance Act, No. 10 of 2015.

General Deductions

ABC (Pvt) Ltd is a company engaged in the business of providing services and the profit before tax for the year ended 31st March 2022 was Rs. 10,550,000. The following expenses have been deducted in arriving at this profit.

1. Salaries paid to employees Rs. 1,000,000.
2. Payment of rent of Rs.1,200,000 for the showroom.
3. Surcharge paid on EPF of Rs. 175,000.
4. The Value Added tax (VAT) paid amounting to Rs.4,500,000. Penalty paid to Inland Revenue due to the delay in payment of VAT of Rs.120,000.
5. Cost incurred in providing food and beverages to the staff in a hotel of Rs. 1,000,000.
6. Provision for gratuity of Rs. 3,000,000. The company has paid a sum of Rs. 1,250,000 as gratuity during the year.
7. Company has charged unrecovered economic service charge (ESC) of Rs. 2,000,000 during the year.

Compute the assessable income from business for the year of assessment 2021/2022.

3.3. Special deduction rules

3.3.1. Interest Expenses (Section 12)

Interest expenses incurred by a person during a year of assessment in relation to a debt obligation is deemed to be an expenditure that has been incurred in the production of income, if it meets the following criteria;

1. The borrowed money should be used to acquire an asset that is used during the year in the production of income; and

2. The borrowed money should be incurred in the production of income.

Accordingly, interest expenses that satisfy the above criteria could be deducted if it has been deriving an income from business or investment.

Interest Expenses

ABC Company is carrying on the business of selling computer accessories. It has obtained a bank loan and utilized the proceeds as follows during the year of assessment 2020/21;

- 50% for construction of office building
- 25% for payment of salaries to the staff
- 25% for the private use of the director

During the year of assessment 2020/21, the interest expense of Rs. 30 Mn. was paid for the loan. During the year of assessment 2021/22 the office building was sold. The interest expense for the year of assessment 2021/22 was Rs. 25 Mn.

Calculate the interest expense that is deductible for the year of assessment 2020/21 and 2021/22.

3.3.2. Deductible amount of financial costs (Section 18)

In addition to section 12, section 18 is also applicable for entities on deductibility of interest expenses. Section 18 restricts the deductibility of interest when calculating the profits from business or investment by an entity, excluding a financial institution. This is referred to as the "thin capitalization rule".

A person incurs a financial cost when the person incurs interest or losses in respect of a financial instrument. Section 198 defines a financial instrument;

(a) means –
  (i) a debt claim or debt obligation;
  (ii) a derivative instrument;
  (iii) a foreign currency instrument; and
  (iv) any other instrument prescribed by regulations or, in the absence of regulations, treated as a financial instrument by generally accepted accounting principles; but

(b) except to the extent as may be prescribed by regulations, excludes a membership interest in an entity.

The above definition specifically excludes shares.

Applying the Thin capitalsation rule

Adjustment from Y/A 2021/22

The law has been changed w.e.f.01st April 2021. The following will be the adjustment;

- This section is only applicable for a company (other than a financial institution) which has a stated capital as at the date on which the year of assessment ends
- It will apply to both local and foreign companies
- Applicable to financial costs deducted in calculating the income from conducting a business or investment
- The calculation will be as follows;

Allowable Finance Cost for the year =	Total Financial Cost / Total value of Financial instruments on which the financial cost incurred during the year	X 4 (Total issued share capital and reserves of the company as at the end of the year)

Financial costs which are not deductible due to the above thin capitalization adjustment can be carried forward and considered incurred during any of the preceding six years of assessment to the extent of any un used limitation after applying the thin cap adjustment.

Thin Capitalisation adjustment

ABC Company is a garment factory and incurs interest expenses relating to a loan obtained to acquire machinery amounting to Rs. 2.5 Mn during the year of assessment 2021/22. The balance sheet of the company as at 31st March 2022 is as follows;

Stated Capital	2,000,000
Revenue Reserves	3,000,000
Revaluation reserves	1,500,000
Long Term loans	30,000,000

Compute the deductible financial cost for the year of assessment 2021/22.

Financial losses

The law enables the CGIR to specify the circumstances under which losses on financial instruments may be set of against gains on financial instruments. The CGIR by Gazette Extraordinary No. 2064/55 dated 1st April 2018 has specified that losses on financial instruments may only be set off against gains from the same type of financial instrument. Accordingly, any excess of the financial loss would not qualify for any further deductions.

3.3.3. Allowance for trading stock (section 13)

A person is permitted to claim a deduction for trading stock costs incurred during the year. Section 195 defines "trading stock";

"trading stock" means assets owned by a person that are sold or intended to be sold in the ordinary course of a business of the person, work in progress on such assets, inventories of materials to be incorporated into such assets and consumable stores;

The definitions of "depreciable asset" and "business asset" exclude trading stock. The definition of trading stock incorporates the traditional distinction between circulating assets and fixed assets.

The characterization of trading stock will depend on the nature of the business in which it is held. For example, land and building where the factory is located which is held in the business for a manufacturing company will be a business asset. However, land and building held in the name of a property developer will be considered as trading stock.

The cost that can be deducted in relation to trading stock for a year of assessment is specified in the law and is calculated as follows;

=Opening value of trading stock (closing value at the end of the previous year)
Add : Expenses incurred during the year on trading stock
Less : Closing value of trading stock (valued at the lower of cost or Market value)

This adjustment delays the deduction of the cost of trading stock until it is disposed. The above calculation follows the generally accepted accounting principles.

Allowance for trading stock

ABC Company has a profit before tax of Rs. 53,950,000 for the year ended 31.03.2022.

The company's value of stocks as at 31.03.2021 and 31.03.2022 were Rs. 70,200,000 and Rs. 97,680,000 respectively. The cost of purchase of stocks during the year of assessment 2021/2022 was Rs. 250,850,000. The company has charged a sum of Rs. 240,500,000 as cost of sales in the income statement for the year ended 31.03.2022.

Compute the tax adjusted profit for the year of assessment 2021/2022.

3.3.4. Research and development expenses (section 15)

Research and development expenses incurred by a person during the year and for the production of income is deductible, irrespective of whether such expenses are of a capital nature or not.

Section 15 defines "Research and development expenses"

"research and development expenses" means expenses incurred by the person in –

(a) carrying on any scientific, industrial, agricultural or any other research for the upgrading of the person's business through any institution in Sri Lanka (or for any innovation or research relating to high value agricultural products, by the person or through any research institution in Sri Lanka); or

(b) the process of developing the person's business and improving business products or process, which shall be beneficial to Sri Lanka,

but shall exclude expenses incurred that are otherwise included in the cost of an asset under this Act.

Any cost that has been treated as a cost of an asset does not qualify to be deducted as research and development expenses.

This is a specific section on deductibility of expenses and it even permits R&D costs even if it is a capital nature expenses. However, it does not allow the person to deduct the cost of purchasing equipment used for the research, but rather allows the cost of assets like intellectual property that is created by the R&D activities.

The Sixth schedule to the IRA provides an additional deduction equal to 100% of the total amount of research and development expenses for five years after 01st April 2018 as a temporary concession.

Research and development expenses

ABC company has a profit before tax of Rs. 23,800,000 and it has carried out a research in its business for improving the quality of the products manufactured by it during the year of assessment 2021/2022. The total expenses charged in Income Statement in relation to cost of materials and labour for research activities of Rs. 3,500,000.

Apart from the above, company has purchased equipment for research purposes amounting to Rs.1,300,000 and which has been capitalized in the balance sheet.

Compute the assessable income from business for the year of assessment 2021/2022.

Research and development expenses

ABC Company incorporated in year of assessment 2020/21 for the purpose of creating a new fertilizer through research and development. The R&D is a two year process. During the year of assessment 2020/21, the company incurs expenses in developing the new fertilizer of Rs. 5 Mn including wages for researchers, the rental of a laboratory, legal fees and materials. However, the research for that year was unsuccessful.

During year of assessment 2021/22, the Company spent another Rs. 10 Mn in R&D costs and this was successful. It has its research patented and it has been recorded in the books of accounts as an intangible property. This was then sold as a permanent exclusive license to use the patent to an investor in Brazil for Rs. 20 Mn.

a. Determine the R&D expenses deductible in the year of assessment 2020/21 and 2021/22.
b. Can ABC company consider the patent as a depreciable asset?

3.3.5. Agricultural startup expenses (section 15)

Agricultural start-up expenses incurred by a person during the year and in the production of income is deductible, even though such expenses may bear the character of a capital cost.

Section 15 defines;

"agricultural start up expenses" means expenses incurred by the person in –

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

For any business, start-up expenses are allowable as a deduction under section 11. However, this section specifically excludes capital nature expenditure. However, section 15 specifically provides that agricultural start-up expenses are deductible even though it is of a capital nature.

Agricultural startup expenses

ABC Company commenced its business of cultivation during the year of assessment 2021/2022. The profit before tax amounts to Rs. 8,300,000 for the year ended 31.03.2022. It has incurred following expenses for its business in relation to a new site developed for its cultivation business.

i.	Cost of purchase of land	10,000,000
ii.	Cost of clearing the land	1,600,000
iii.	Cost of purchase of tractors	1,500,000
iv.	Cost of construction of fences	700,000
v.	Cost of cultivation	2,200,000

All the expenses other than the cost of cultivation has been capitalized to the assets and has been reflected in the balance sheet. Compute the assessable income from business for the year of assessment 2021/2022.

3.3.6. Marketing and communication expenses (section 15) (w.e.f. 1st April 2021)

Marketing and communication expenses incurred by a person in the production of income during the year of assessment can be deducted irrespective of whether it is of capital nature or not.

"marketing and communication expenses" means, any expenses incurred by any person in-

(a) carrying out a market research by such person or any institution in Sri Lanka on his behalf;

(b) the development or production of marketing, advertising and communication campaign to the extent that such development or production is carried out in Sri Lanka;

(c) advertising on mainstream media or social media including television, radio, print or as outdoor advertising;

(d) product launches or campaign activation carried out by such person or by any local institution on his behalf;

(e) development and printing of point-of-sale material by such person or by any local institution on his behalf.".

Therefore, any expenses falling within the above definition can be deducted when computing the assessable income from a business.

Marketing and communication expenses

ABC Company is in the business of selling powdered coconut milk. The company has decided to launch a liquid coconut milk product in August 2021. The board of directors has approved the following expenses.

i. Market research done by another Market research institution Rs.5,000,000 spent in June 2021
ii. Developing a marketing, advertising and communication campaign 2,500,000 spent in April 2021
iii. Product launch event to be spent in August 2021 - 1,000,000
iv. Advertising in television, social media, print media and hoardings 25,000,000 spent during the period June to August 2021

Determine the expenses that are deductible when computing the assessable income from business of ABC Company.

3.3.7. Capital Allowances and balancing allowances (section 16)

The main deduction rule specifies that capital expenditure is not deductible when determining the person's profits from business. However, in the case of depreciable assets, there is a special provision that provides for a deduction as capital allowance on assets that are owned and used by the person in the production of income.

Capital allowances and balancing allowances are allowed as a deduction only in calculating a person's income from business only.

In section 195, depreciable assets are defined as;

"depreciable asset" –
(a) means an asset to the extent to which it is employed in the production of income from a because of wear and tear, obsolescence or the passing of time; but
(b) excludes goodwill, an interest in land, a membership interest in an entity and trading stock;

Accordingly, the conditions that need to be satisfied to claim capital allowances are;

1. Depreciable assets must be owned by the person – legal ownership or ownership of the asset in any other way as specified in the IRA. For example, section 49(2) provides that lessee has the ownership of the assets obtained on finance lease.

2. The depreciable assets must be used by the person as at the end of the year of assessment in the production of income
3. The assets employed will diminish in value due to wear and tear by constant use, obsolesce or by effluxion of time
4. If any depreciable asset is entitled for a deduction of depreciation allowance, then such amount cannot be differed to a future period/s.
5. If the asset is partly used in the production of income from a business, the cost and consideration received for the asset shall be apportioned according to the market value of that part of the asset that is used in the production of income from that business.

Calculating capital allowances

The Fourth schedule to the IRA provides;

1. Capital allowance is granted on a depreciable asset on straight line method based on the following formula;

   $$A/B$$

   A – is the depreciation basis of an asset at the end of the year of assessment

   B – is the number of years specified for that is applicable to that asset

2. Full depreciation allowances will be granted for the year of acquisition is such depreciable asset in used up to the end of the year of assessment. No depreciation allowance will be granted for the year of disposal of such asset as it does not exist at the end of the year of assessment.

3. No depreciation allowance is allowed on road vehicles, other than –
   (a) a commercial vehicle;
   (b) a bus or minibus;
   (c) a goods vehicle; or
   (d) a heavy general purpose or specialised truck or trailer.

   "commercial vehicle" means–
   (a) a road vehicle designed to carry loads of more than half a tonne or more than 13 passengers; or
   (b) a vehicle used in a transportation or vehicle rental business.

4. Depreciable basis of a depreciable asset shall be the sum of
   i. Depreciation basis of the asset at the end of the previous year of assessment (written down value of the asset)
   ii. Amounts added to the depreciation basis of the asset during the year of assessment in respect of additions to the cost of asset.

For the purpose of calculating the capital allowances, the depreciable assets which have been categorized into 5 classes of assets and the number of years applicable to the relevant depreciable asset has been stated in the Fourth schedule as follows;

Class	*Depreciable Assets*	*No. of years*
1	computers and data handling equipment together with peripheral devices.	5
2	buses and minibuses, goods vehicles; construction and earthmoving equipment, heavy general purpose or specialized trucks, trailers and trailer-mounted containers; plant and machinery used in manufacturing.	5
3	railroad cars, locomotives, and equipment; vessels, barges, tugs, and similar water transportation equipment; aircraft; specialised public utility plant, equipment, and machinery; office furniture, fixtures, and equipment; any depreciable asset not included in another class.	5
4	buildings, structures and similar works of a permanent nature.	5
5	intangible assets, excluding goodwill.	The actual useful life of the intangible asset, or where the intangible asset has an indefinite useful life, 20.

Capital allowances

ABC Company is a garment factory. It acquired a machine on 01st July 2020 at a cost of Rs. 1 Mn and used it in the production of income. Assume it is continually used for the next five years.

Calculate the depreciation allowance for the next five years.

Capital Allowances

ABC Company incorporated in April 2021 has acquired the following assets (classified as motor vehicles) during the year of assessment 2021/2022.

Advise the company whether it can deduct capital allowances in relation to these motor vehicles.

1. Lorry purchased for transporting of goods
2. Car purchased for marketing director for his official travelling
3. Car purchased for rental business

Capital Allowances

ABC Company was incorporated in April 2021 and it is engaged in the business of manufacturing consumable products. The profit before tax for the year ended 31.03.2022 was Rs. 23,500,000. The accounting depreciation of Rs. 17,250,000 was deducted in arriving at the said profit.

The Company has purchased the following assets during the year of assessment 2021/2022.

1. Machinery of Rs. 60,000,000 which include a sum of Rs. 10,000,000 obtained under finance leasing
2. Equipment of Rs. 2,500,000
3. Office furniture of Rs. 2,400,000
4. Computers and accessories of Rs. 1,300,000
5. Building constructed of Rs. 15,000,000
6. Building purchased of Rs. 10,500,000
7. Software purchased of Rs. 1,500,000

The said amount of depreciation includes cost of amortization on computer software (intangible asset) of Rs. 150,000 made based on useful life of the asset.

Compute the assessable income from business for the year of assessment 2021/2022 in computing business income.

Transitional provisions

Transitional provisions contained in Gazette Extraordinary No. 2064/53 dated 1st April 2018 carries provisions that permit a person to claim capital allowances on any capital assets acquired prior to 1st April 2018 in accordance with the provisions of the IRA of 2006. This applies to the following classes of assets;

1. Capital assets acquired prior to 1st April 2006
2. Any qualified building constructed or any building acquired prior to 1st April 2006
3. Capital assets acquired after 1st April 2006 but prior to 1st April 2018, any qualified building constructed, or any building acquired prior to 1st April 2018.

Claim of capital allowances for the assets acquired prior to 01.04.2018
The rates of depreciation allowance depend on the category of assets.

1. Information technology equipment and calculating equipment (including accessories and software)
   a. Software developed in Sri Lanka 100%
   b. Others 25%
2. Any motor vehicle 20%
3. Any furniture 20%
4. Plant or machinery
   Acquired on or after April 01, 2011 33 1/3%

5. Buildings
   a. For qualified building
      i. Prior to April 01, 2011 6 2/3%
      ii. On or after April 01, 2011 10%
   b. For Other buildings
      i. Prior to April 01, 2015 6 2/3%
      ii. On or after April 01, 2015 10%

Capital Allowances – Transitional provisions

ABC Company has furniture purchased during the year of assessment 2017/18 for a cost of Rs. 6 Mn and has used this furniture during the year of assessment 2021/22.

Compute the capital allowance deductible in the year of assessment 2021/22.

Balancing allowances (Disposable loss)

Balancing allowances are

(a) made in respect of depreciable assets
 a. Realized during a year of assessment and
 b. In respect of which depreciation allowances have been granted in that year or an earlier year and

(b) Calculated in accordance with the provisions of the second and further schedule.

Balancing allowance = written down value of the asset – consideration received

Assessable charges (Disposal profit)

Assessable charges forms part of the person's business income and will be calculated in accordance with the following formula;

Assessable charges = consideration received - written down value of the asset

> **Balancing charges**
>
> ABC Company has disposed the following assets during the year of assessment 2021/2022.
>
> 1. A machine sold for Rs.8,000,000 was acquired by the company on 14.09.2019 for Rs.12,000,000.
> 2. A lorry sold for Rs. 1,000,000 was purchased by it on 19.08.2017 for Rs. 4,000,0000.

3.3.8. Improvements (section 14)

Expenses in relation to improvements of a depreciable asset is deductible, irrespective of whether it is in the nature of capital expenditure, provided that the following criteria are satisfied;

a. The expense must be incurred during the year
b. The expense incurred should be in relation to the production of income from business or investment
c. The deduction claimed is subject to the limitations specified in the law.

The limitation specified in the law are as follows;

Type of asset	Limitation on deductibility
Building, structures and similar work of a permanent nature	5% of the written down value of the asset at the end of the previous year
All other assets	20% of the written down value of the asset at the end of the previous year

Further, what will constitute an improvement has also been elaborated in the Act as follows;

"improvement" means the expenditure incurred by a person to make additions or alterations to a depreciable asset which enhances the value of such asset, but excludes the expenditure incurred to maintain or repair a depreciable asset which temporarily enhances the value of such asset."

Improvements

Identify which of the following expenses can be deducted when computing the assessable income from business after 1st April 2021;

- Rs. 3,000,000 spent on improving the capacity of a machine from producing 1000 tins per hour to 1,200 tins per hour
- Rs. 4,500,000 spent on improving the speed of a motor car used in the business from 80kmh to 100kmh
- Rs. 1,200,000 spent to replace a defective motor in a machine used in the production
- Rs. 150,000 spent to cushion office chairs
- Rs. 450,000 spent to replace all the fluorescent bulbs in the factory to LED lamps

The deduction is permitted in the year in which the expense is incurred. Any sum that cannot be claimed as a deduction due to the limitation of deductibility, qualifies for a deduction by way of a capital allowance. Accordingly, the excess is aggregated to the tax written down value of the respective asset and depreciated over the remaining useful life of the asset starting from the following year of assessment. Improvements made after the expiration of the number of years where capital allowances are claimed, will not be allowed as the value of the depreciation basis and number of years will be zero.

Improvements

ABC Company is a garment factory. It acquired a machine on 01st July 2020 at a cost of Rs. 1 Mn and used it in the production of income. Assume it is continually used for the next five years. The machine was improved in the year of assessment 2021/22 at a cost of Rs. 400,000/-.

Calculate the;

1. Deductible expense in the year of assessment 2021/22
2. Depreciation allowance for the next five years.

Improvements

ABC Company has incurred cost of improvement in respect of depreciable assets during the year of assessment 2021/2022. The cost incurred for each class of asset with its written down value as at 31.03.2021 for income tax purposes are as follows.

	Building	Machinery
Written down value	72,500,000	N/A
Cost of improvement	2,950,000	10,300,000

The machinery was acquired by the company during the year 2021/2022.

Compute the deductible cost for the year of assessment 2021/2022.

3.3.9. Losses on realization of business assets and liabilities (section 17)

Section 17 provides the deduction of loss from the realization of assets and liabilities in calculating the person's income from business. Losses incurred on the realization of the following assets and liabilities qualify for deduction;

(a) capital assets of a business to the extent to which the assets were used in the production of income from the business; and

(b) liabilities of a business to the extent to which –

  (i) in the case of a liability that is a debt obligation incurred in borrowing money, the money was used or an asset purchased with the money was used in the production of income from the business; and

  (ii) in the case of any other liability, the liability was incurred in the production of income from the business.

3.3.10. Business or investment losses (section 19)

Section 19 provides the deduction of loss in calculating the person's income from business or investment.

Loss calculation

Section 19(6) provides;

"loss" of a person for a year of assessment from a business or investment shall be calculated as the excess of amounts deducted in accordance with this Act (other than under this section or subsection (5) of section 25) in calculating the person's income from the business or investment over amounts included in calculating that income;"

"unrelieved loss" means the amount of a loss that has not been deducted in calculating a person's income under this section or subsection (5) of section 25.

A loss is calculated to be the excess of deductions made in terms of the IRA over the amounts included as income. Accordingly, a claim on account of a loss is made after all other deductions have been claimed.

Loss deduction rules

1. An unrelieved loss of the person for the year from a business can be deducted from any other business of that person.
2. An unrelieved loss of the person which has not been deducted within the previous six years of assessment from the business income or any other business can be deducted.
3. An unrelieved loss which is eligible to be deducted for a year of assessment cannot be deferred to another year of assessment.
4. Where a loss, if it were a profit, would have been subject to tax as a reduced rate, such reduced rate loss can be deducted only from same reduced rate or lower rate or exempt profit. However, where a company has operated as a "Small and Medium enterprise" and claimed the lower rate of 14% under this category, and has incurred losses, such losses can be set off against the profits of the company once it ceases to fall within the SME definition.
5. The above loss deduction rules apply on treatment of investment losses other than the losses from the disposal of investment assets.
6. An unrelieved loss from a business may be deducted in calculating the income from business or investment.
7. An unrelieved loss from investment can be deducted only in calculating income from investment.
8. Gain from realization of an investment asset shall not be deducted by any loss on the disposal of another investment asset.

Section 19 – Losses

ABC Company engaged in the business of manufacturing, has both local sales as well an exports. Assume the company earns the following profits/losses from business, and has no other income;

Y/A	Profit/(loss) from Exports (Rs.)	Profit/(loss) from local sales (Rs.)
2021/22	(1,500,000)	750,000
2022/23	1,000,000	(250,000)
2023/24	1,000,000	(1,500,000)
2024/25	(400,000)	(700,000)

Compute the taxable profits from business and the loss deduction schedule for each of the above years of assessment.

Losses

ABC Company has incurred business loss of Rs. 20 Mn. from its manufacturing operations during the year of assessment 2021/2022. It has earned Rent income from its investments amounting to Rs. 7.5 Mn.

Advise the company whether the said loss from business can be deducted from its rent income (investment income).

Losses

ABC Company has incurred business loss of Rs.5,000,000 from its manufacturing operations while generating business income (profit) of Rs.12,000,000 from the business of trading operation during the year of assessment 2021/2022.

Advise the company whether the said loss from manufacturing business can be deducted against the profits from trading operation.

Transitional Provisions

A loss that has been incurred under the IRA of 2006 and brought forward to the year of assessment. 2018/19 is deemed to be a loss incurred during the year of assessment 2018/19 under the IRA of 2017 and deductible as permitted under the IRA of 2017.

Losses – Transitional provisions

The income tax computation of ABC company for the year of assessment 2017/2018 recorded a loss carried forward to the year of assessment 2018/2019 amounting to Rs. 20 Mn. The company report further tax adjusted losses amounting to Rs. 2Mn, Rs. 3Mn and Rs. 5Mn in the year of assessment 2018/19, 2019/20 and 2020/21 respectively. The adjusted profit from business for the year of assessment 2021/22 is Rs. 35Mn.

Advise the company whether the loss brought forward from Y/A 2017/18 can be deducted from the profits in the year of assessment 2021/2022 and compute the tax adjustment profit liable to income tax for the year of assessment 2021/22.

3.3.11. Reverse of amount including bad debts (section 24)

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

A. Recovery of expense deducted is an Income (Sec. 24(1))

Where a person deducts an expense in calculating the person's income and the person later recovers the expense, the person shall, at the time of recovery, include the amount recovered in calculating the person's income.

B. Refunding of income is a deduction (Sec. 24(2))

Where a person includes an amount in calculating the person's income, because of a legal obligation to do so, and the person later refunds the amount, the person shall, at the time of refund, deduct the amount refunded in calculating the person's income.

C. Disclaimer of expense deducted is an income (Sec. 24(3))

Where, in calculating income on an accrual basis, a person deducts an expense that the person is obliged to make and the person later disclaims an obligation to incur the expense, the person shall, at the time of disclaimer, include the amount disclaimed in calculating the person's income.

D. Disclaimer or write off of income as bad debts is a deduction (Sec. 24(4) and 24(5))

Where in calculating income on an accrual basis, a person includes an amount to which the person is entitled and the person later –

(a) disclaims an entitlement to receive the amount; or

(b) in the case where the amount constitutes a debt claim of the person, the person writes off the debt as bad.

The person may, at the time of disclaimer or write off, deduct the amount disclaimed or written off in calculating the person's income.

Bad debt write off

ABC Company has a profit before tax of Rs. 15,400,000 for the year ended 31.03.2022. The following transactions have been recorded during the year;

1. It has maintained a provision for doubtful debts account for the year ended 31.03.2022 and the amount charged to the income statement as provision during the year is Rs.1,200,000. Out of which a sum of Rs. 400,000 represents specific provision and the balance of Rs. 800,000 is general provision.
2. It has written off a total sum of Rs. 400,000 out of the general provision made in the previous year of assessment, the breakup of which is as follows.
   - For trade debts of Rs. 240,000
   - For staff loans of Rs. 160,000

Compute the assessable income from business for the year of assessment 2021/2022.

3.3.12. Bad debt provision for banking business (section 66)

A person conducting banking business can make specific provision for bad debts as per the directives made by the central bank of Sri Lanka but the deductible amount from such provision will be specified by the CGIR. The extra ordinary gazette No. 2064/57 dated 01st April 2018 specifies the items which are to be excluded from the provision in computing the amount deductible for income tax purposes as follows;

(1) No provision made in respect of potential risk of credit facilities in accordance with the relative directives made by the Central Bank of Sri Lanka.

(2) No provision made in respect of pawing debtors in the business of pawn broking carried on by a Financial Institutions in accordance with the relative directives made by the Central Bank of Sri Lanka.

(3) No provision made in respect of a debt claim given to an associated person.

(4) No provision made in respect of a debt claim given to a person outside Sri Lanka.

3.4. Deduction of Expenses from Investment Income

Applicability of deduction rules on expenses depends on whether the relevant amount constitutes income from business or income from investment. Accordingly, following sections are not applicable in calculating the person's income from investment.

i. Section 13 – Allowance for trading stock
ii. Section 14 – Repairs and improvements
iii. Section 15 – Research and Development expenses and Agricultural start up expenses
iv. Section 16 – Capital allowances and balancing allowances
v. Section 17 – losses on realization of business assets and liabilities.

Rent as Investment Income

Mr. Perera acquires an office building in the year of assessment 2021/22 for Rs. 50 Mn. He earns a rent income of Rs. 6 Mn for the year. He incurs expenses in the form of commission for the services of the property manager amounting to Rs. 600,000 and rates of Rs. 75,000. He has spent Rs. 2.5 million during the year to repair the building.

Discuss the following;

1. Can Mr. Perera consider the rent income as Investment income in the year of assessment 2021/22
2. Is the commission paid, rates paid and repair expenses deductible?
3. Can Mr. Perera claim capital allowances?
4. Are there any other deductions that Mr. Perera is entitled to.

CHAPTER REVIEW EXERCISES

Question 1

COCO (Pvt) Ltd is a subsidiary of Interglobe (Pvt) Ltd and engages in the business of manufacturing garments only for the export market. The statement of income of COCO (Pvt) Ltd for the Y/A 2021/22 is as follows:

	Rs.
Turnover	12,550,000
Less: Direct cost	(5,153,000)
Gross profit	**7,397,000**
Other income - gain on disposal of quoted shares	1,400,600
- profit from asset disposal	150,000
Less: Administrative expenses	(4,634,500)
Selling and distribution expenses	(2,173,200)
Finance cost	(920,000)
Net profit for the year	**1,219,900**

The following additional information has been provided.

i. Accounting depreciation charged for the Y/A amounts to Rs. 1,950,000.

ii. Royalty paid to a non resident person charged in the income statement was Rs. 300,000 and no withholding tax has been deducted when making the payment.

iii. Furniture purchased for Rs. 2,700,000 in the Y/A 2019/20 had been disposed of, for Rs. 1,900,000.

iv. Allowance for depreciation had been granted in full for all assets other than the motor coach purchased during the Y/A for transport of factory staff for Rs. 2,226,500. The motor coach can carry 35 passengers.

v. During the Y/A, having obtained the approval of the Divisional Secretary of the area, the company renovated a government school, by incurring Rs. 620,000.

vi. All other expenses are allowable for the purpose of income tax.

vii. Total of income tax paid on self-assessment, during the Y/A was Rs. 75,000.

Required:
Compute the gross income tax liability and balance tax payable by COCO (Pvt) Ltd for the Y/A 2021/22.

Question 2

Ayubowan Sri Lanka (Pvt) Ltd (ASL) is a company providing educational courses in English, Maths and IT to school children. The statement of income for the Y/A 2021/22 is as follows:

	Rs.
Service income	60,350,000
Less: direct cost	(38,200,000)
Gross profit	**22,150,000**
Other income - interest income from fixed deposits (gross)	2,400,000
- profit from disposal of computers	1,080,000
Less: administrative expenses	(12,100,000)
other expenses	(3,300,000)
Net profit for the year	**10,230,000**

The following additional information has been provided.

i. Accounting depreciation charged for the Y/A amounts to Rs. 5,300,000.

ii. During the Y/A, ASL had donated Rs. 800,000 worth of goods to an approved charity which provides institutionalised care for orphaned children.

iii. Property, plant and equipment

  a. During the Y/A the company had purchased information technology equipment amounting to Rs. 16 million.

  b. The company had disposed of its old computers for a consideration of Rs. 5,200,000. The computers had a tax written down value of Rs. 4,500,000 at the time of disposal.

  c. ASL had also purchased a mini bus for Rs. 2,800,000 for staff transport purposes on 1 May 2021. (capacity 30 passengers)

  d. Capital allowances had been granted in full, for all the assets other than assets purchased during the year.

iv. All other expenses are allowable for the purpose of income tax.

v. The company has an unabsorbed loss of Rs. 1,240,000 as at 31 March 2021.

vi. Total income tax self-assessment payment made for the Y/A is Rs. 625,000.

Required:

Compute the income tax liability and the balance tax payable by ASL (Pvt) Ltd for the Y/A 2021/22.