

VAT on Financial Services

Chartered Accountancy Strategic Level Corporate Taxation (TAX)

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14. VAT ON FINANCIAL SERVICES

1. Chargeability

VAT on Financial services was introduced with effect from 01.01.2003 by amendment Act No. 7 of 2003. The financial services are exempt from normal VAT. The VAT on financial service which was introduced under Chapter IIIA of the Value Added Tax Act is not based on the input/output concept. The tax is charged on the book profit.

Section 25A of the VAT Act provides;

VAT on financial services shall be charged in accordance with the provisions of this Chapter with effect from 01.01.2003 **on the supply of financial services** in Sri Lanka made by any person (13 of 2004) which carries on a business of supplying such financial services.

It was originally introduced on Bank and Financial Institutions which are registered under the Banking Act or Finance Company Act and with effect from 01.07.2003 it has been extended to any person providing similar services. However effective from 01.01.2008 a co-operative society is exempted from VAT on financial services and from 01.01.2011 the services of Unit Trusts and Mutual Funds are treated as not financial services. Central Bank is exempted effective from 01.07.2003 by amendment Act No. 17 of 2013.

Persons liable for VAT on FS

Advise whether following persons are chargeable with VAT on financial services.

1. A bank registered under the Banking Act
2. A finance company
3. A pawn broker
4. A company which is engaged in business of general insurance
5. A company which is engaged in business of life insurance
6. A company which sells goods on hire purchase terms
7. A person providing financial consultancy services

Accordingly, the following conditions should prevail for a person to be liable for VAT on financial services.

- (i) a person who supplies "financial services". The supply of financial services is defined in section 25F.

2. Supply of financial services

Supply of financial services have been defined in Section 25F of the VAT Act as follows;

- “(a) the operation of any current, deposit or savings account;
- (b) the exchange of currency;
- (c) the issue, payment, collection or transfer of ownership of any note, order for payment, cheque or letter of credit;
- (d) the issue, allotment, transfer of ownership, drawing, acceptance or endorsement of any debt security, being any interest in or right to be paid money owing by any person other than the transfer of nonperforming loans of a licensed Commercial Bank to any other person in terms of a re-structuring scheme of such bank as approved by the Central Bank of Sri Lanka with the concurrence of the Minister;
- (e) the issue, allotment, transfer of ownership of any equity security or a participatory security;
- (f) issue, underwriting, sub-underwriting or subscribing of any equity security, debt security or participatory security;
- (g) the provision of any loan, advance or credit;
- (h) the provision –
 - (a) of the facility of instalment credit finance in a hire purchase conditional sale or credit sale agreement for which facility a separate charge is made and disclosed to the person to whom the supply is made ;
 - (b) goods under any hire purchase agreement or conditional sale or hire purchase agreement while have been used in Sri Lanka for a period not less than twelve months as at the date of such agreement”

3. Total Value Addition

Tax is payable on the total value addition of the institution which includes net profits or losses (before any deduction for payment of income tax) computed in accordance with the accepted accounting standards, subject to adjustment for VAT and NBT payable on supply of Financial Services. However, then the profit or loss for each taxable period cannot be accurately ascertained, such amount can be estimated on the basis of available information and such estimated amount should be adjusted to reflect the actual amount on half yearly basis. It has been amended effective from 01.01.2013 that the adjustment should be made to reflect the actual amounts with the audited statement of accounts on yearly basis and such adjustment should be submitted within 6 months after the closing date of accounts.

Any person adopting Sri Lanka Financial Reporting Standard (SLFRS) shall take into account the operating profit for this purpose.

3.1. Calculation of total value addition

Net profit or loss (before income tax expense)		xxxx
Add - Emoluments payable	xxxx	
Book Depreciation	xxxx	
VAT and NBT on financial services (charged to the income statement)	<u>xxxx</u>	xxxx
Less - Economic Depreciation	xxxx	<u>(xxx)</u>
Total Value Addition		<u>xxxx</u>

3.1.1. Emoluments payable

The aggregate amount of cash benefits and non cash benefits payable to all the employees including any payment, contribution or provision in relation to terminal benefits which is charged to the income statement in arriving at the operating profit.

3.1.2. Economic Depreciation

The rates of economic depreciation determined by the Minister and published in the Gazette Notification No. 1606/30 of 19.06.2009 are as follows;

Asset	Rate (per annum)
Data processing equipemnt and accessories including computer software	25%
Vehicles	20%
Other Machinery, Plant, Equipment, Furniture, Fixture & Fittings	12.5%
Intangible assets (other than Goodwill)	10%
Buildings	6 2/3%

3.2. Calculating value addition on attributable method

The calculation of tax is done on attributable method from 01.01.2014. This method can be used;

- i. If separate accounts are maintained for financial services and non-financial services the value addition shall be calculated separately.
- ii. If no separate accounts are being maintained the value addition attributable for financial services shall be calculated on a proportionate basis.

Under this method the net profit from financial services to be ascertained separately by removing the net profits applicable to the following services being non-financial services.

1. Exempt supplies other than financial services
2. Zero rated supplies
3. Other taxable supplies on which tax is paid
4. Profits from intercompany loans other than to a company, within a group of companies which is providing financial services
5. Interest income by an approved provident fund, including Employees Trust Fund, Pension Fund or any thrift, saving or building society or welfare fund to which contribution is made by employees only, or any approved gratuity fund, or interest income (not being business income) by an Institution other than financial institutions.
6. Dividend income other than to a person registered for VAT on financial services
7. Profit from sale of shares other than to a person registered for VAT on financial services
8. Profit from the exchange of currency, other than profits arising to a person primarily in the business of providing financial services which is liable to VAT.

Calculation of the Value Addition attributable to financial service =

$$\text{Total value addition} \times \frac{\text{Value of financial services}}{\text{Total value of supplies}}$$

- Value of Financial Services - The aggregate turnover from financial services as per income statement of the audited statement of accounts.
- Total value of supplies (turnover) - Total turnover as per income statement of the audited statement of accounts excluding leasing capital

This proportionate basis is applicable where there is no material difference in the recognition of receipts for the calculation of profits and for the calculation of turnover.

3.3. Calculation of Tax

Value Addition attributable		xxxx
Less - VAT on financial service payable	xxx *	
NBT on financial service payable	<u>xxx</u>	<u>xxx</u>
Value addition after tax		xxxx
VAT Payable		
Value addition after tax x 15%		xxxx

*To be calculated applying VAT+NBT fraction on the total value addition.

3.4. Rate of Tax

For the period from 02nd May 2016, the rate of tax will be 15%.

The rate from 01st Janaury 2022 will be 18%.

4. Tax Administration

4.1. Threshold for registration

Every specified institution or other person carries on the business of financial services in Sri Lanka, shall be required to register where the value of such supply for a period of three months exceeds Rs. 75,000,000 or for a period of twelve months exceeds Rs. 300,000,000, if such registration has taken place for any period on or after 01.01.2020. (9 of 2021)

4.2. Return Filing obligation

Effective from 01.01.2011 the taxable period is six months. The taxable period is twelve months for any taxable period commencing on or after 01.01.2017.

The Return for the year ending on 31st December should be furnished on or before 30th September for any taxable period commencing on or after 01.01.2017. However, for any person who close the accounts on 31st March, the taxable period may commence from 1st April to 31st March with the approval of the Commissioner General.

4.3. Payment of tax

The liable person shall pay tax on a monthly basis on or before the 20th day of the succeeding month subject to making any final adjustment, if any, when submission of the Return.

However, for the taxable period on or after 01.01.2017, the tax payable on a monthly basis shall be adjusted for the total liability for every six months period on the interim estimate referred to in section 25C(b) and payable with the submission of the interim estimate, if the monthly payments made are less than the tax as per the interim estimate. Where such tax is not so paid, such tax shall be deemed to be in default.

4.4. Regulations

Every registered person should follow the guidelines issued by the CGIR and the relevant guidelines are specified in the Gazette Notification No. 1868/10 dated June 23, 2014 issued for this purpose.

CHAPTER REVIEW EXERCISES

Question 1

The income and expenditure details of XY bank are as follows;

Total turnover for the year ended 31.03.2021 is as follows;

	Rs. '000
Lease rental (Capital 240,000 + interest 60,000)	300,000
Hire purchase rental (include charges 20,000)	80,000
Interest on loan	350,000
Interest on F/D	40,000
Interest on treasury bills and bonds	30,000
Consultancy Fees	40,000
Management fees	130,000
Commission and other charges	20,000
Income from dealing in securities	40,000
Interest from pawning	100,000

Notes

- The net profit for the year ended 31.03.2021 before tax is Rs. 360 million
- Lease interest relating to agreements entered after 25.10.2014 is Rs. 20 million.
- VAT and NBT on financial service charged to profit and loss Rs. 48 million
- Depreciation claimed for the year Rs. 60 million
- Economic Depreciation calculated for the year Rs. 108 million
- Salary paid for the year is Rs. 440 million. Salary includes Retirement gratuity Rs. 4 million (charged to the P& L) However, pension to ex-directors Rs. 1,200,000 and Staff medical expenses Rs. 800,000 were not included. EPF and ETF contribution by employer if Rs. 60 million.

Compute the VAT on FS liability.

Question 2

ABC Limited is a limited liability company which is engaged in the business of a pawn broker. Apart from the pawn brokering business, it also provides consultancy services which are liable for normal VAT.

Its summarized income statement for the month of March 2021 is given below.

Interest income from pawn brokering		40,000,000
Income from consultancy services		<u>20,000,000</u>
		60,000,000
Less: Expenses		
Administration expenses	15,000,000	
Selling and distribution expenses	17,000,000	
Other expenses	5,000,000	<u>37,000,000</u>
Net profit for the month		<u>23,000,000</u>

The following information is relevant.

i. Administration expenses include the following.

Depreciation	Rs. 2,200,000
Salaries	Rs. 8,000,000
EPF and ETF	Rs. 1,200,000
Gratuity provision	Rs. 600,000

ii. Selling and distribution expenses include the following.

VAT on financial services	Rs. 1,800,000
NBT on financial services	Rs. 360,000
Entertainment	Rs. 1,500,000
Commission paid	Rs. 3,000,000
Provision for debtors	Rs. 2,500,000

iii. Company has following assets acquired.

Computers and accessories	- Y/ A 2018/2019	Rs. 2,500,000
Motor cars	- Y/ A 2019/2020	Rs. 8,000,000
Office furniture	- Y/ A 2019/2020	Rs. 3,200,000
Office equipment	- Y/ A 2020/2021	Rs. 1,700,000

Required;

Compute the liability of VAT on financial services for the month of March 2021 based on the available information.