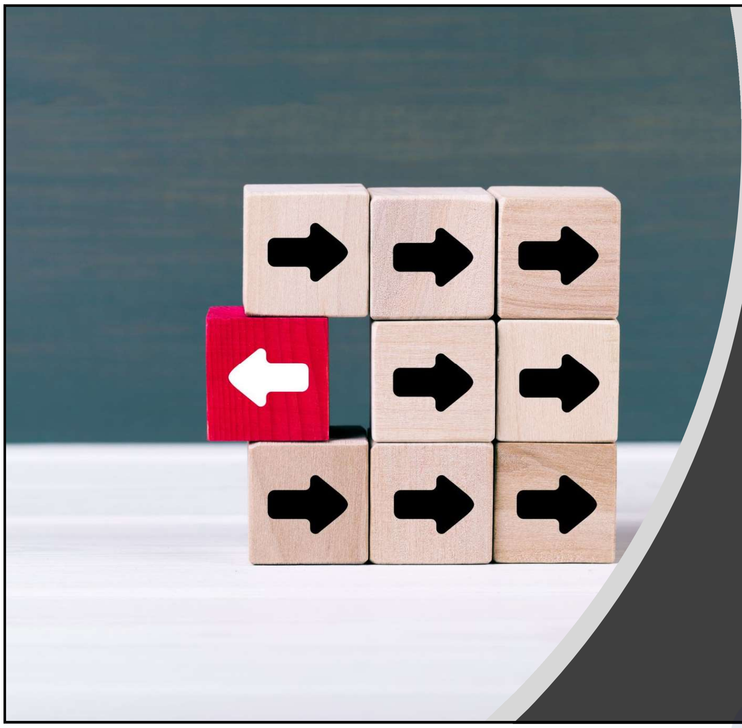

Gain on realization of assets and liabilities

Chapter IV (Sec 36 – 51)

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Introduction

A Gain can be ………………

As per Sec 6(2)(c) - Business income

- Gain from the realization of Capital Assets and liabilities of the business

As Per Sec 7(2)(b) - Investment income

- Gain from the realization of Investment Assets - Capital gain

The new Inland Revenue Act, taking effect on 1st April 2018, introduces capital gains tax (CGT) on the ‘realization’ of investment assets.

Meaning of capital asset

"capital asset" –

a) means each of the following assets:-
   - land or buildings;
   - a membership interest in a company, partnership or trust;
   - a security, or other financial asset;
   - an option, right or other interest in an asset referred to in the foregoing paragraphs; but

a) excludes trading stock or a depreciable asset;

Meaning of capital asset

"land or buildings" includes a structural improvement to land or buildings, an interest in land or buildings or an interest in a structural improvement to land or buildings, and includes the following:—

(a) a lease of land or buildings;

(b) a lease of a structural improvement to land or buildings; or

(c) an exploration, prospecting, development, or similar right relating to land or buildings; and

(d) information relating to a right referred to in paragraph (c);

Meaning of capital asset

"membership interest" in an entity means a right, whether of a legal or equitable nature, including a contingent right, to participate in income or capital of the entity and includes the interest of a partner in a partnership, the interest of a beneficiary in a trust and shares in a company;

Meaning of Investment asset

"investment asset" –

(a) means a capital asset held as part of an investment, but-

(b) excludes the principal place of residence of an individual, provided it has been owned by the individual continuously for the three years before disposal and lived in for at least two of those three years (calculated on a daily basis);

Gains from assets and liability

Chapter IV of the Act deals with the calculation of gains from assets and liability

- The gain is calculated as the ***consideration* received** for the asset or liability exceeding the ***cost* of the asset or liability at the time of *realisation***
- A gain made by a person on the realisation of an investment asset shall be reduced by any part of the gain that is included in calculating the person's income from an employment or business.

Gains from assets and liability

- Where an asset or liability owned by a person is used in the production of two or more sources of income, the cost of and consideration received for the asset shall be apportioned between each source according to the market value of the parts used to produce each source.
- Where, in any year of assessment commencing from April 1, 2021, an asset owned by a person is used in the production of different gains and profits from business (including losses) taxable at different tax rates, the cost of, and consideration received for the asset shall be apportioned among such gains and profits, according to the market value of the parts of the assets used to produce respective gains and profits.

Realisation of assets and liability

a) When that person parts with ownership of the asset, including when the asset is sold, exchanged, transferred, distributed, cancelled, redeemed, destroyed, lost, expired, expropriated or surrendered;
b) In the case of an asset of a person who ceases to exist, including by reason of the death of an individual, immediately before the person ceases to exist;
c) In the case of an asset other than trading stock or a depreciable asset, where the sum of consideration received from owning the asset exceeds the cost of the asset;

Realisation of assets and liability Contd..

d) In the case of an asset that is a debt claim owned by a person, the person reasonably believes the debt claim will not be satisfied, where the person has taken reasonable steps in pursuing the debt claim and the person writes the debt off as bad;

e) In the case of trading stock, a depreciable asset, a capital asset of a business or an investment asset, immediately before the person begins to employ the asset in such a way that it ceases to be an asset of any of those types; and

f) In the circumstances change of residence. (Sec 70)

Realisation (Summary) – Sec 39

- When the owner of the asset transfers the ownership of that asset by way of,
  - Sale ,exchange , transferrer ,distribute, cancel, loss ,destroy
- Death of an individual
- Realisation with retention of asset –
  - Lease ,write-off debt, change of residence

Calculating gain and losses

Consideration received (Sec 38) for the asset or liability exceeds the cost of the asset (Sec 37) or the liability(Sec 40) at the time of realization (Sec 39)

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

Consideration Received - Sec 38

1) Consideration received for an asset shall be [Sec 38 (1)]
   a) - Amount received or receivable on the realisation - cash
      - In the case of consideration received other than cash - market value
        Ex: Exchange of asset to an another asset
   b) Amount received in respect of owning the asset
        Ex : Altering ,repair
   c) Amount received or entitlement to received in future- advance

Notwithstanding anything to the contrary in subsection (1), the consideration received for the realisation of an investment asset of a person shall be the amount received or receivable by the person in respect of such asset or the assessed value at the time of realisation, whichever is higher :

- Provided, however, a tax official may determine the consideration received for an asset in terms of subsection (1), if such tax official is of the opinion that the assessed value is not indicative of the market value of such asset.
- For the purpose of this subsection, "assessed value" means the value at the time of the realisation, certified by a professionally qualified valuer in a valuation report.

Consideration Received - Sec 38 (Contd..)

2) Grant of an option - only if the person has not been subject to tax in respect of any income or gain made on the grant of the option

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

Cost of an asset 37(1)

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

Transitional Provisions - sec 203 (4)

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

When to consider income amount as a cost ?

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

Income amount - Example 01

AZY (Pvt) Ltd is a company engaged in the business of real estate, Company has given Mr Ziya who is one of its executives, a plot of land as a bonus. The market value of the land is Rs 500,000. This amount shall be included in calculating the assessable income of Mr Ziya from the employment and it shall be considered as cost of the asset. Mr Ziya sells the land in year 3 for Rs 720,000.

Calculation of gain as follows.

Sales consideration	= 720,000
Costs of the land	= 500,000
Gain	= 220,000

Example 02

- Mr Sameera purchased a 60 purch land on 21.10.2015 for Rs 2,000,000/-. He has sold 30 purch of the land for Rs. 3,500,000/- on 30.09.2017 . He has incurred a cost of Rs. 500,000/- on 06.10.2019 for set up access road and draining system to the remaining block. He sold that block of land on 01.05.2022 for Rs 5,000,000/-
- For the completion of the transaction he has incurred advertising expenses Rs 10,000/- and lawyer fee Rs . 200,000/-. Market value of the land as at 01.05.2022 Rs 6,000,000/-
- His tax consultant came with the following tax computation. Please make your comment on the below tax computation.

Consideration received		= 5,000,000
Less : Cost of an asset		
Purchses cost of the land	1,000,000	
Add : Improvement cost	500,000	
Add : Incidental expenditure	210,000	= 4,210,000
Gain from investment asset		= 790,000
Capital gain Tax @ 10 %		= 79,000

Grant of an option

An option is an agreement between the grantor, or writer, and the grantee. Typically, the grantor gives the grantee the right to buy or to sell a specified quantity of something such as shares, land or any capital assets at a price fixed by the option agreement. This right can only be exercised during a specific period or on a specific day.

Grant of an option

Example 03

Mr. Matheesha pays to Mr. Anthoney Rs 1,000,000 for the grant of an option entitling the holder to acquire a land from Mr. Anthoney for Rs. 5 Mn. Mr. Matheesha subsequently did not exercise the option and sell the option to Mr. Perera for Rs. 2 Mn.

Grant of an option

Liabilities

- Cost of a liability calculated according to Sec 37
- Consideration calculated according to Sec 39
- Realization of liability will arise ,when person ceased to owe the liability by way of
  - Transfer , satisfy, cancel
  - Death
  - Change in residence

Liabilities

Example 04.

Company XYZ (Pvt.) Ltd (XYZ)is a fully owned subsidiary of Company ABC Ltd. XYZ has applied for a banking facility from X Bank Co Ltd. However, due to the high gearing situation, bank has not entertained the facility. XYZ was able to obtained a gurentee facility form the parent company. ABC has paid Rs. 1,000,000/- as the process fee of guarantee and recovered the same from XYZ.

Total facility was Rs. 50Mn and interest accumulated as of 30.08.2022 was Rs. 5Mn. XYZ was unable to settled the total facility. X Bank has recovered the total due from the parent company.

XYZ has settled Rs. 30Mn to parent company as the full settlement of the facility.

Division II -Realization of assets (Sec 42-51)

- Realisation with retention of asset
- Transfer of asset to spouse or former spouse(Death or divorce)
- Transfer of asset on death
- Transfer of asset to an associate or for no consideration
- Involuntary realisation of asset with replacement
- Realisation by separation

Realisation with retention of asset (deem realisation) [Sec 43]

This means that ownership of the assets is not actually transfer to another person, deem realization take place

Realization an asset in any manner set out in paragraph (c) to (f) of section 39 -

(Consideration received from owning the asset ,Write – off debt ,Change of residence)

[39 (c)] In the case of an asset other than trading stock or a depreciable asset, where the sum of consideration received from owning the asset exceeds the cost of the asset.

[39 (d)] In the case of an asset that is a debt claim owned by a person, the person reasonably believes the debt claim will not be satisfied, where the person has taken reasonable steps in pursuing the debt claim and the person writes the debt off as bad;

[39 (e)] In the case of trading stock, a depreciable asset, a capital asset of a business or an investment asset, immediately before the person begins to employ the asset in such a way that it ceases to be an asset of any of those types; and

[39 (f)] In the circumstances change of residence. (Sec 70)

Realisation with retention of asset (deem realisation)

43(a) Person treated as transfer of ownership – Market value

43(b) Person treated as reacquiring the asset – Market value

Transfer of asset to spouse or former spouse/on death or divorce [Sec 44]

The transfer of asset to spouse of former spouse on death, or as part of a divorce settlement or bone fide separation agreement the gain calculated as following formula and for this purpose written consent is required.

- Sec 44(a)

The individual shall be treated as deriving an amount in respect of the realisation equal to the net cost of the asset immediately before the realisation;

Realisation = Net Cost of the asset immediate before the realisation

Transfer of asset to spouse or former spouse/on death or divorce [Sec 44]

- Sec 44 (b)

  The spouse or former spouse shall be treated as incurring expenditure of the amount referred to in paragraph (*a*) in acquiring the asset.

  Acquisition cost = Net Cost immediate before the realisation

Therefore, by applying above formula, gain will not arise

Transfer of asset on death to any other person (Sec 45)

- Sec 45(a)

  an individual is treated as realizing all of his or her assets and liabilities immediately before his or her death. In principle, the deceased is treated as receiving net cost at the time of death in respect of the disposal. The result is that the death of an individual is a non-taxing event as regards gains and losses on assets and liabilities.

  Realisation = Net Cost of the asset immediately before his or her death

Transfer of asset on death to any other person (Sec 45)

- Sec 45(b)

  Instead, the person who acquires ownership of the asset will be treated as having incurred the same net cost in acquiring the asset from the deceased, and any gain derived by such person relative to the net cost upon subsequent disposal will be taxed in the hands of such person

  Person who acquire ownership of asset equal to net cost

  Acquisition cost = Net Cost immediately before the death of the deceased person

Transfer of asset to an associate or for no consideration - Sec 46

[46 (1)]Where a person realises an asset by way of transfer of ownership of the asset to an associate of the person or by way of transfer to any other person by way of gift.

The transfer of any type of asset, it can be business asset of investment asset by way of transfer ownership to associate or giving gift.

Sec 46(2) and (4) provides exception to general rule 46(1)

46(2) provided exception to the general rule for an individual and charitable institutions who transfer land or a building situated in Sri Lanka for the associate in relation to the individual. If individual transfers capital asset other than land and building 46(1) apply and gain calculated accordingly.

Transfer of asset to an associate or for no consideration - Sec 46

The term associate has been defining in the sec 46(3) (a)

a) in the case of a transfer to an associate–

i. the associate in relation to the individual is the individual's child by marriage or adoption, spouse, parent, grandparent, grandchild, sibling, aunt, uncle, nephew, niece or first cousin; and

ii. the asset is an interest in land or a building situated in Sri Lanka; or

b) in the case of a transfer to a charitable institution, the transfer occurs by way of gift.

Transfer of asset to an associate or for no consideration - Sec 46

[46 (4)] Where a person realises an asset, being trading stock, a depreciable asset, an investment asset or a capital asset of a business, by way of transfer of ownership of the asset to an associate of the person and the requirements of subsection (5) are met –

a) the person shall be treated as deriving an amount in respect of the realisation equal to the net cost of the asset immediately before the realisation; and

b) the associate shall be treated as incurring expenditure of the amount referred to in paragraph (*a*) in acquiring the asset.

Transfer of asset to an associate or for no consideration - Sec 46

[46 (5)].

a) the person or the associate is an entity;

b) the asset or assets are trading stock, depreciable assets, investment assets or capital assets of a business of the associate immediately after transfer by the person;

c) at the time of transfer (on or after 01st April 2021)

   i. the person and the associates are residents;

   ii. in the case of an associate partnership, any of its partners, or the associate, is not exempt from income tax; and

   iii. the tax rate applicable on the person's gain from the realisation of an asset referred to in subsection (4) is equal or less than the tax rate which is applicable on the gain of the associate from realisation of such asset; and

d) there is continuity of underlying ownership in the asset of at least fifty *per cent*.

Transfer of asset to an associate or for no consideration - Sec 46

Example 05

Company AK (Pvt.) Ltd (AK) is incorporated in Sri Lanka and holding equity ownership of the following companies incorporated in Sri Lanka.

TK (Pvt.) Ltd (TK) – 80% Owned by Company AK

SK (Pvt.) Ltd (SK) – 40% owned by Company AK and 30% Owned by Company TK

SK Company disposed a land to TK Company. Cost of the land is Rs. 30Mn

Calculate the gain on the realization of the Land and tax liability if any

Transfer of asset to an associate or for no consideration - Sec 46

Section	Application	Realisation	Criteria
46(1)	Transfer of asset to an associate or for no consideration	Net cost or Market value which ever is higher	Other than Section 46(2) 46(4)
46(2)(3)	Transfer of asset to an associate of the individual or charitable institution	Net cost	• Individual (associate) - child by marriage or adoption, spouse, parent, grandparent, grandchild, sibling, aunt, uncle, nephew, niece or first cousin • charitable institution • Only applicable for land and building situated in SL
46(4)(5)	Person who transfer trading stock , depreciable asset, investment or capital asset of business	Net cost	• Person or associate is an entity - Sec 196 • Asset transfer need to be business asset of an associate • Person and associate need to be resident • Underlying ownership(Asset) – more than 50%

Involuntary realisation of asset with replacement (Sec 47)

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

Involuntary realisation of asset with replacement (Sec 47)

47(a)

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

47(b)

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

Involuntary realisation of asset with replacement (Sec 47)

Mr. X own land and government decide to compulsory acquisition. The detail of asset disposed as follows

Asset	Net cost	Consideration received	Acquisition of new asset
Land	2 M	3 M	2.5 M

Calculation - Land

47(a)	Realization	=	Net cost	+	if Compensation received exceeds cost of replacement asset
	2.5 M	=	2 M	+	0.5 M(3 M – 2.5 M)
	Gain	=	Realization	-	Net cost
	.5 M	=	2.5 M	-	2 M
47(b)	Cost of replacement asset	=	Net cost	+	If cost of replacement asset exceeds compensation received
	2 M	=	2 M	+	Not exceed (2.5 M- 3 M)

Realisation by separation – Sec 48

- Right and obligation - Permanent (last long for more than 50 years)
- Part realisation
  - Ex : Land lease for more than 50 years
- Rights or obligations – Temporary (less than 50 years)
- Acquisition of new asset
  - Ex : Land lease less than 50 years

Apportionment Sec 51

- Where a person acquires more than one asset or liability or realises more than one asset or liability.
- The market value and net cost have to apportioned

Cost 30 M

Sale 35 M

Land

MKT value	=15 M
Cost	= 10 M
	= 5 M

Building

MKT value	= 20 M
Cost	= 20 M

Exemption – Third schedule

a) A gain made by resident individual from the realization of an investment asset not exceeding Rs 50,000 per transaction and total gains not exceed Rs 600,000 per year of assessment ,

b) Gain made by a resident individual from realization of the principle place of resident

- Individual owned asset for continuously for three years and
- lived in by the individual for at least two of those three years

c) Gain from realization of shares listed in the Colombo Stock Exchange

Exemption – Third schedule

d) gain made by an entity fully owned by the Government of Sri Lanka as a gain from the realisation of a capital asset or liability of the business or realisation of an investment asset, if such gain was made due to any decision by the Government of Sri Lanka as being essential for the economic development of Sri Lanka and subject to the prior written approval of the Minister.

e) a gain made by a person on or after April 1, 2021, but prior to October 1,2022, from the realisation of land or building which was sold, exchanged or transferred to a real estate investment trust listed in the Colombo Stock Exchange and licensed by the Securities and Exchange Commission of Sri Lanka.

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Capital Gain tax rate ,Tax return and payment

- Capital gain tax rate – 10 % (Company 30% with effect from 01.10.2022)
- Capital gain tax return – Submit within one month from the month of the realization of an investment asset.
- Capital gain tax payment – Within one month from month of the realization of investment asset.
- As per Sec 19(5) - a gain from the realization of an investment asset shall not be reduced by any loss on the disposal of another investment asset.

Thank you