July 2021 – 2(b)

- In the case of Strong v Woodifiled, the business was letting of rooms as innkeepers. One visitor while visiting the inn was injured due to the fact that a chimney fell in. The innkeepers had to pay the visitor damages.
- For tax purposes, the matter to be decided by court was whether the amount paid as damages to the visitor can be deducted when computing the taxable profits.
- The judge in this case held that such expenses are not incurred for the production or earning of income. It is not sufficient that an expense is merely connected with the business, or arises out of the business, if such expense is not incurred in generating any income.
- Based on the above decision, the damages paid by GHP will also not be deductible as paying damages to a patient is not an expense that will contribute towards GHP earning any income while engaging in its business as a private healthcare service provider.
- Section 11 of the IRA which gives the main deduction rule provides, that an expense can be deducted to the extent that it is incurred in the production of income from the business or investment.
- GHP has paid damages to the patient as compensation for the loss of his finger during a surgery carried out by a surgeon practicing in the hospital.
- The payment is paid as compensation which implies that there has been a mistake on the part of the surgeon and therefore, the Department of Inland Revenue can challenge that this is not an expense that is incurred in the production of income but rather as a payment to mitigate some mistake. Therefore, it is not directly linked with GHP earning any income from providing healthcare services.
- On this basis the about paid as compensation may not be deductible for income tax purposes under section 11.

VAT Revision

MEMO

TO : BOARD OF DIRECTORS - Premier Lanka (Pvt) Limited (PLPL)

FROM : FINANCE MANAGER

SUBJECT : TAX IMPLICATIONS ON DEFERRED PAYMENT PROGRAMME

DATE : 18TH JUNE 2022

BACKGROUND

As a part of marketing strategy, the company is considering a proposal to implement an extended deferred payment programme for certain categories of its local clients.

Financial cost is considered when pricing the products under this programme. As per the company's financial reporting policy, the interest element included in the price will be recognized separately in the financial statements.

INCOME TAX IMPLICATIONS

- The interest charged on the deferred payment plan will be recorded as interest income in the financial statements of PLPL and this income will be liable for income tax.
- PLPL is currently liable to pay income tax at the following rates;
  - Manufacture and sale – liable at 18%
  - Exports – liable at 14%
- The interest income earned by PLPL will be considered as business income as it is effectively connected with the business of the company when making sales locally.
- Therefore, the interest income will be taxed at 24% since this income cannot be linked with manufacturing but rather an income generated outside the manufacturing process.
- Any losses incurred in the business taxed at 14% or 18% can be set off against the interest income earned from the deferred payment plan.

VAT IMPLICATIONS

- VAT Act in the first schedule lists the goods and services which are exempt from VAT.
- This includes supply of financial services, including "(g) the provision of any loan, advance or credit"
- Therefore, the interest income earned from the deferred payment plan will not be liable for normal VAT.
- However, section 25A of the VAT Act specifies that VAT on financial services will be charged on the supply of financial services by any person. The rate applicable will be 15%.

December 2021 – Q3(b)

Criteria to consider when evaluation a financing method

- The investor in USA can channel his investment into Sri Lanka either as equity, where he purchases the shares of the Sri Lankan company. The return on this investment will be dividend.
- The IRA in the third schedule in item (oo) provides an exemption on dividend paid by a resident company to a shareholder who is a non-resident person.
- Therefore, the foreign investor will not have to bear any tax cost in Sri Lanka on the return on his income.
- The investor alternatively can channel his investment as a loan/debt to the company in Sri Lanka. The return on this investment will be interest.
- The IRA in the third schedule in item (i) provides an exemption on the interest accruing to or derived by a person outside Sri Lanka on any loan granted to any person in Sri Lanka.
- Therefore, the return on investment on a loan given by a foreign investor will also not attract any tax in Sri Lanka.
- Therefore, in respect to the foreign investor, there is no distinction on the tax cost on whether the investment is channeled to Sri Lanka as equity or debt.
- However, in respect to the local company in Sri Lanka, any dividend is distributed after the income tax has been paid on profits. Interest costs are however, deductible for income tax purposes subject to section 12 and 18 of the IRA.

- Therefore, if the money is channeled as a loan to the Sri Lankan company and such money is used to purchase assets or in the production of income, the finance cost can be deducted in arriving at the taxable profit.
- The interest paid will reduce the profit and therefore, the income tax paid by the company in Sri Lanka will be reduced.
- However, the deduction of the finance cost is subject to a cap under section 18. Therefore, the company should evaluate the total finance cost deductible subject to the thin capitalization rule.

INCOME TAX IMPLICATIONS ON THE PROPOSED INVESTMENTS

The investor is currently having the following options when making an investment in Sri Lanka;

1. Option 1 – invest in IOSL
2. Option 2 – invest in the assembly plant

Option 1 – Invest in IOSL

The second schedule to the IRA provides certain investment incentives. However, these incentives are only available to a new entity. Since IOSL is an existing entity, the investment incentives will not be available.

IOSL will be liable to income tax at the normal corporate income tax rate of 24% since it does not qualify for any concessionary tax rates.

Option 2 – Invest in the assembly plant

The proposal is to incorporate a new company in Sri Lanka to build a plant for assembling, printing and other communication equipment. Since this is a new entity, the Investment incentives provided in the second schedule to the IRA will be available.

Where the investment is between USD 3 million and USD 100 million and the investment is not in the Northern province, then capital allowances can be claimed for 100% of the expenses provided that the following criteria are satisfied;

- Investment has to be in depreciable assets, other than intangible assets
- Investment has to be done during the year of assessment
- Assets have to be used in a part of Sri Lanka other than the northern province

This additional capital allowance is available in addition to the normal capital allowances provided under the 4th schedule to the IRA. Where the additional capital allowances result in a loss, such loss can be deducted over the succeeding 10 years of assessment.

Tax rate

Since the company will be exporting its products, it can claim the concessionary rate of 14% available for exports under the 1st Schedule to the IRA.

(ii)

The proposed investment is for LKR 2,500 million. The project is expected to take 18 months for implementation. During this time, since the company will not have any output VAT, any input VAT paid on the purchases during the project implementation period will be a cost to the company.

Section 22(7) of the VAT Act provides that

> "Where any person has proved to the satisfaction of the Commissioner-General, that such person has commenced any business or any project in Sri Lanka, and undertakes to make taxable supplies in respect of such business or project within a period of thirty months from commencement of such operation, then (w.e.f.1/4/2004), he may register such person subject to such conditions as may be specified by him, notwithstanding the provisions of section 14 and allow credit for input tax in respect of such business or project subject to the provisions of sub-paragraph (iii) of subsection (6). Further, where the Commissioner-General is satisfied that in consideration of the nature of the project that the period of thirty months is not sufficient to commence the making of taxable supplies, he may extend the period on the basis of an application made by such registered person to that effect (w.e.f.1/4/2004)"

Based on the above section, the company can ask for VAT registration under section 22(7) and claim the input VAT paid during the project implementation period. All person registered under section 22(7) can also register under the SVAT scheme as a RIP and when making purchasers, the VAT can be suspended. This is when purchases are made from persons registered as RIS. Where such registration has not been obtained by the purchaser, the company can get a refund on the input VAT paid.

Therefore, the new company can avoid the cash outflow as VAT when making purchases by registering under section 22(7) of the VAT Act.