Business Income – Advance Aspects

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Finance Cost

- The treatment for finance cost or the interest expense will change based on the year of assessment.

Year of Assessment 2021/22 ***(AA Section 10)***

- For year of assessment 2021/22 a concept called **Thin Capitalization.**
- Under thin capitalization the amount of finance cost that can be allowed as a deduction from business income was limited a ceiling.
- Limit is required to be calculated as follows.

$$\frac{\textbf{Finance Cost for the year}}{\textbf{Value of the financial instruments}} \times (4 \times \textbf{Equity excluding revaluation reserves})$$

Finance Cost

Illustration

Below is an extraction of the interest expenses and the equity for Tront Co.

Interest Expense
Working capital loan Rs. 200,000.
Business loan Rs. 500,000.
Personal loan of director Rs. 200,000.
Overdraft for business purpose Rs. 250,000.

Total borrowings outstanding were business borrowings Rs. 80,000,000 and personal borrowings Rs. 10,000,000.

Equity
Capital Rs. 500,000.
Retained earnings Rs. 15,000,000.

Calculate the allowable interest expense for 2021/22.

Finance Cost

- If there is any brought forward unclaimed interest expense is there from any previous tax year that can be deducted up to the given limit.

Year of Assessment 2022/23 onwards ***(AA Section 56.11)***

- No limit is applicable and any amount of business related finance cost can be claimed.

Research and Development Cost

- For R&D any expense irrespective of whether it is capital or revenue nature shall be treated as an allowable expense. *(Section 15.1)*
- However, if any R&D expense is added to the value an asset, such shall be excluded.
- Further an additional deduction equal to 100% of the expense will also be granted. *(Sixth Schedule)*
- The additional deduction is applicable only up to 2022/23.
- Below expenses are treated as R&D. *(Section 15.1)*
  - Scientific, industrial, agricultural or any other research for upgrading the business through an institute in Sri Lanka.
  - Developing business process or the product of the business.

Marketing and Communication Exp

- With effect from 01st of April 2021, expenses relating to marketing and communication can also be treated as allowable expenses irrespective of whether they are in capital or revenue nature. *(Section 15A, AA8)*
- The below expenses can be considered under the above.
  - Market research.
  - Marketing and advertising campaign carried out in Sri Lanka.
  - Advertising in mainstream media or social media including television, radio, print or as outdoor advertising.
  - Product launches.
  - Development and printing of point of sale materials.

Agricultural startup expenses *(Section 15)*

- Similar to R&D agricultural startup expenses are also considered as allowable expenses irrespective of whether they are capital or revenue in nature.
- Below expenses are considered for this purpose.
  - Opening up a land for cultivation or animal husbandry.
  - Cultivating such land with plants.
  - Purchase of livestock or poultry to be reared at such land.
  - Maintaining tanks or ponds for rearing fish.
  - Clearing preparation of inland waters for rearing fish.
  - Purchase of fish for rearing in any of the above.

Enhanced Capital Allowances *(Second Schedule)*

- Apart from the usual capital allowances granted an enhanced capital allowance will also be granted for selected new investments.
- Expansion of the existing business does get qualified for enhanced capital allowance.
- Only tangible assets will be considered.
- Below are the limits considered for enhanced capital allowance.

Enhanced Capital Allowances *(Second Schedule)*

Criteria	Investment Limit	Percentage
Depreciable assets used in Sri Lanka other Northern province	USD 3Mn – 100Mn	100%
	Above USD 100Mn	150%
Depreciable assets used in Northern province	Above USD 3Mn	200%
Assets or shares of a state owned company	Above USD 250Mn	150% to the state owned company

Enhanced Capital Allowances *(Second Schedule)*

- Apart from the above;
  - Expenditure up to USD 3Mn in other than Northern province shall be granted with an enhanced capital allowance of 100%.
  - In Northern province 200%.
- All the limits given above are annul limits. In order to claim enhanced capital allowance the expenses incurred during an year of assessment shall be considered.
- Enhanced capital allowance are applicable up to 2022/23.

Repairs *(Section 14)*

- Under this section any cost of repair of a depreciable asset shall be considered as allowable expenses from 01st of April 2021.
- Repair expenses means expenses incurred in respect of a depreciable asset which does not have a material impact on the value of the asset.

Improvements *(Section 14, AA 7)*

- Improvement means an expense spent with regards to an addition or alteration to a depreciable asset which will enhance the value of the asset.
- Improvement expenses are allowed to be deducted subject to a limit as follows.
  - Class 4 depreciable asset 5% of the written down value at the end of the previous year.
  - In all other cases 20% of the written down value at the end of the previous year.
- Any balance unclaimed amount can be added to the **depreciation basis** of the asset.

Leases *(Section 31)*

- A lease agreement means an agreement between two partied where one party grants the other party right to use an asset for a specific periodic payment.
- In accounting we call this as **Right Of Use (ROU).**
- Mainly we have two different types of lease agreements.
  - Finance Lease.
  - Operating Lease.
- Under this section we are going to focus on the treatment for finance leases under income tax.

Finance Lease *(Section 31)*

- A lease agreement with below characteristics will be considered as a finance lease.
  - Transfer of ownership at the end of the lease tenor.
  - Lessee has an option to purchase the asset at a agreed price.
  - Lease term exceeds 75% of the useful life time of the asset.
  - Estimated market value of asset after the end of the lease period is less than 20% of the market value at start of the lease.
  - Present value of the minimum lease payments equals or exceeds 90% of the market value of the asset.
  - Asset is so customized only the lessee will be able to use the asset after the end of the lease period.

Finance Lease *(Section 31)*

- **Lease assets purchased prior to 01st April 2018**.

Leases

IT equipment	Non IT related
Lower of; ¼ of the total lease value or Actual lease repayments	Lower of; 1/5 of the total lease value or Actual lease repayments

Total lease value = Lease rental x Total number of lease rentals

- No capital allowances shall be granted and no interest can be deducted.

Finance Lease *(Section 31)*

Illustration

Tront Co. has the below leases outstanding as of 31.03.2022.

Lease of a lorry on 01.05.2017 on 60 lease rentals and each rental was Rs. 35,000.

Sever PC on 01.06.2017 on 5 years lease where the leas rental was Rs. 20,000.

Finance Lease *(Section 31)*

Leases after 01.04.2018

- Lessee will be treated as the owner of the asset.
- Lessee can claim capital allowances.
- Rental repayments cannot be deducted.
- Interest payments can be deducted.

Finance Lease *(Section 31)*

Disposal of Leased assets purchased before 01.04.2018

- Asset will be considered as a fully depreciated asset.
- Therefore, the entire sales proceeds will be subject to tax after deducting any cost of acquisition.

Disposal of Leased assets purchased after 01.04.2018

- Treat as a usual depreciable asset.