

# Introduction to Taxation

## Part 01

### AAT Level III

#### Corporate & Personal Taxation (CPT)

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## CHAPTER 01

# INTRODUCTION TO TAXATION

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- ✓ Functions & principles of taxation
- ✓ Current tax system in Sri Lanka

## 1.0 INTRODUCTION TO TAXATION

Tax is a compulsory charge imposed by the Government. Even though it has no direct benefit, there is an indirect benefit to the public at large.

Government collect revenue in the form of taxes, charges or borrowings. As per the central Bank Annual Report 91% of the total revenue represents tax revenue.

Taxes are imposed in two forms as direct and indirect taxes. Direct tax is levied directly on personal & corporate income and profits. Whereas indirect tax is levied on the price of a good or services.

### 1.1 History Of Taxation In Sri Lanka

The colonial Government introduced income tax system in Sri Lanka in 1932. After the independence in 1948, the tax system in Sri Lanka underwent several changes such as introduction of wealth tax, Gift tax and Expenditure tax. Subsequently these taxes were abolished, however income tax continued to be in force.

The main indirect tax, namely turnover tax, was introduced in 1981 and was transformed in to goods and services Tax (GST). Later goods and services Tax (GST) was substituted by value added Tax(VAT).

#### Question 01

Why do Governments charge various taxes?

## 2.0 FUNCTIONS & PRIMARY OBJECTIVES OF TAXATION

Functions of taxation can be separated into primary function, economic function & social function.

## 2.1 Primary Function Of Taxation

- ✓ Raising funds for public expenditure.  
 Examples for public expenditures: Free medical services, infrastructure facilities, security & law, free education service

## 2.2 Economic Function Of Taxation

- ✓ Set local & foreign investment direction
- ✓ Protect local industries from foreign competition

## 2.3 Social Function Of Taxation

- ✓ Discourage activities which are desirable by the society
- ✓ Encourage activities which are desirable by the society
- ✓ Reduce income disparity between rich and poor

### Question 02

Determine the functions of taxation

## 3.0 PRINCIPLES OF INCOME TAXATION

Government collects taxes in order to fund the public expenditure. However, in framing the tax policy, the government takes in to account the following basic tax principles

### 3.1 Equality

The unique feature of an income tax relative to other forms of taxation is that it is based on a person's ability to pay. I.e. all people should bear the public expenditure in proportion to their respective abilities.

### 3.2 Certainty

The tax to be paid should be certain and not arbitrary. A taxpayer should be able to understand the rules on time of payment, manner of payment, amount to be paid etc.

### 3.3 Convenience

Tax should be collected by the state in a manner which is convenient to the tax payer. For instance;

- Income Tax is collected on installment basis.
- Pay As You Earn Tax (PAYE) & Withholding Taxes (WHT) is collected at the point of payment.

### **3.4 Simplicity**

Income Tax Laws should be clearly understandable to any person. This is the keystone of an efficient tax system. Simplicity leads to more efficient administration, avoiding unnecessary litigation, encourage compliance, and lesser tax evasion.

### **3.5 Progressivity**

The principle of progressivity means that higher income groups should pay proportionately more than the lower income groups. This is simply called as vertical equity.

### **3.6 Productivity/Adequacy**

The tax system should be productive enough, i.e. it should ensure sufficient revenue to the government and it should encourage productive activity by encouraging the people to work, save and invest.

### **3.7 Diversity**

There should be diversity in the tax system of the country. The burden of tax should be distributed widely on the entire people of the country.

### **3.8 Stability**

An income tax structure once designed with care and long-term objectives in view, must as far as possible be unchanged except for inflation adjustments for a considerable length of time.

### **3.9 Economy/Efficiency**

The minimum possible cost to be spent to collect the tax and the maximum part of the tax collection to be passed on to the Government.

#### **Question 03**

List and briefly explain the principles of income taxation?

## **4.0 DIRECT AND INDIRECT TAXES**

Direct tax is a tax paid by a person on whom it is levied. In other words, as far as direct taxes are concerned, the impact and the incidence fall on the same person. It is borne by the same person on whom it is levied and it cannot be passed on to others. In the context of Sri Lanka, income tax is the main direct tax.

In case of indirect taxes, unlike in direct taxes, the impact and incidence fall on different persons. It is not borne by the person on whom it is levied and can be passed on to others. The main indirect tax system prevailing in Sri Lanka is value added tax.

#### 4.1 Differences Between Direct & Indirect Tax

Details	Direct Tax	Indirect Tax
<b>Imposition of payment</b>	Direct taxes should be paid by taxpayer directly to the government	Indirect taxes are collected by a person other than the person on whom the tax is imposed
<b>Shifting of tax burden</b>	Tax burden cannot be shifted	Tax burden can be shifted to the final consumer
<b>Collection</b>	Collection cost is high	Collection cost is low
<b>Tax burden</b>	Progressive	Regressive
<b>Example</b>	Income Tax	VAT & NBT

#### Question 04

Differentiate between direct tax and indirect tax by giving applicable taxes in Sri Lanka?

#### Question 05

From the angle of effective collection of tax, out of direct tax and indirect tax, which is the better taxation?

### 5.0 CURRENT TAX SYSTEM IN SRI LANKA

#### 5.1 Major Taxes Operates In Sri Lanka & Collecting Authorities

Major taxes that operate in Sri Lanka and collecting authorities are as follows;

Relevant Authority	Type of Tax
Department of Inland Revenue	<ul style="list-style-type: none"> <li>Income Tax (IT)</li> <li>Value Added Tax (VAT)</li> <li>Nation Building Tax (NBT)</li> <li>Economic Service Charge (ESC)</li> <li>Stamp Duty (SD)</li> <li>Construction Industry Guarantee Fund Levy</li> </ul>
Department of Customs	<ul style="list-style-type: none"> <li>Taxes on imports &amp; exports</li> </ul>
Excise Department	<ul style="list-style-type: none"> <li>Excise Duty on tobacco &amp; liquor</li> </ul>

#### Question 06

List the major taxes that operate in Sri Lanka with the collecting authorities?

## 5.2 Components Of Law Applicable To Income Tax System In Sri Lanka

### 5.2.1 The Inland Revenue Act

The main act which is applicable to the imposition of income tax in Sri Lanka is the Inland Revenue Act No.24 of 2017.

### 5.2.2 Gazette Notifications

From time to time, ministers or administrators issue gazette notifications with regard to the act.

Such gazette notifications would become part of the legal framework for taxation.

### 5.2.3 Case Law

Under common law principles, the decision of higher courts become precedent and are considered examples in subsequent matters.

Therefore, previously decided cases on tax matters will also become part of the legal framework for tax.

Ex: Mahavitharana Vs CIR , Ramishwara Vs CIR

### 5.2.4 Rulings

In order to achieve uniformity on contentious issues in administrating the tax system, tax administrators (Department of Inland Revenue) may issue rulings.

Ex: Public & private rulings

### 5.2.5 Notices published in newspapers

Tax administrators may publish notices on certain matters. Such notices form part of the regulatory framework for tax.

Question 07

What are the Components of law applicable to taxation in Sri Lanka