SUBMISSIONS ON THE PROPOSED INLAND REVENUE BILL

1. Reference to Generally Accepted Accounting Principles

   The new Act refers to accounting profits being the basis of computing taxable profits. Currently certain incomes and expenses that are considered for accounting purposes are not considered for tax purposes either as income or expenses. The reason being for accounting incomes and expenses are accounted more on the substance of the transaction than its legal form. Under the current Act these transactions are ignored when the tax liability is computed. A classic example is property revaluations that are accounted as income or expenses and are ignored for tax purposes since the income or the expenses is unrealized and there is no cash to pay the tax. Therefore, reference to accounting profits in the new Act should be removed.

   The current Act deals with capital assets fairly easily. In the new Act the method of claiming capital allowances, the sale of the asset and treatment of the resulting gain/loss has been unnecessarily complicated. If section 25 of the current Act is maintained then complication introduced by the new Act can be avoided. In fact there is one schedule and a chapter unnecessarily allocated for capital assets when this could be dealt very simply under the current Act.

2. No credit for Withholding Tax on interest

   In the new Act no credit is granted for Withholding Tax deducted on interest income arising on treasury bills, Cooperate debt securities and on fixed deposits for companies. As a result the effective tax rate of investment income in the above instruments for a corporate will be around 38% (28% and 14%). If no credit were granted against tax deducted on interest income, such law would be against all forms of equity and justice.

3. Dividends

   Although, section 84 and 88 says that the dividend tax deducted by the paying company is a final withholding and the recipient is not taxed further these sections do not deal clearly as in the current law with regard to dividends distributed out of dividends received. The understanding was that the current taxation on dividends will be maintained which would mean it will be a final tax and will not be taxed in the hands of the recipient and will not be taxed once these dividends are redistributed by the recipient company. Hence, the redistribution part has not been included in the new Act.

Also, there are certain dividends paid without any withholding tax by companies that have entered into agreements with the BOI and under the Strategic Development Act. We believe that these commitments will be honoured under the new Act and therefore express provisions will be included.

4. EPF and Terminal benefits paid to an employee

The understanding was that the current method of taxing retirement benefits paid to an employee from an approved superannuation fund would continue. However, the exemption schedule refers only to the ETF and not the EPF or an approved provident fund. Hence, the current exemption from income tax for any payments made by the EPF or an approved provident fund to an employee needs to be included along with the ETF.

Also, currently the employers' contribution to an approved provident fund is a deductible expense to the company. As per the new Act it is not a deductible expense unless the employee is taxable on that contribution at the time of retirement from the company. This needs to be included to maintain the current status. Further, the Act refers to an approval of the Fund by the Minister. In any event no new Funds can be approved after 1996 under the EPF Act and also even in the past only the approval of the CGIR was required and not the Minister. Hence, the reference to the Minister is not relevant and if not it will require all these Funds approved since 1956 to once again receive the approval of the Minister.

Currently the income of a provident fund including the EPF is taxed at the rate of 10%. In the new Act there is no provision that offers the low rate of 14% to a provident fund. Also, with the proposal not to grant credit against Withholding Tax deducted on cooperate debt securities, Government debt securities and fixed deposits to companies (provident funds are deemed to be companies under the new Act) the effective tax rate of a provident fund increases from current rate of 10% to 38%. A provident fund has been granted a concessionary tax rate by successive governments because such funds consists of employees' savings to be paid at the point of retirement.

5. Interest income for individuals

In the last budget it was proposed that in the case of an individual the 5% deducted on interest on fixed deposits would be a final tax. In the new Act it does not appear very clearly whether this would be final tax in the hands of individual.

6. Deductions

"Expense of a capital nature" has been defined under this section to include an expense that secures a benefit lasting longer than twelve months. This interpretation appears to be illogical. However, an expense whether capital or revenue cannot be decided, currently the decision will be taken based on case laws.

7. Gain on sale of shares in public quoted companies

   The new Act appears to be exempting from income tax the gains arising on the sale of shares only if it is held as an investment. However, the understanding with the Minister was to maintain the current status and exempt the gains from the sale of a quoted share whether it is business or investment and whether it arises to an individual or a company.

8. Capital Allowances

   Calculation of Capital allowances as per the proposed Act is complex. Depreciable assets are required to be categorized into five pools depending on the type of asset. For three pools of assets the capital allowances are calculated on a reducing balance method and the balance two pools are calculated on a straight-line basis. At the point of a disposal of an asset the tax treatment for the calculation of the profit on disposal differs.

   There also seems to be a restriction in carrying forward unclaimed capital allowances, which is of significant concern for businesses that are capital intensive in nature and have a relatively long gestation period. We suggest calculation of capital allowances is maintained as per the existing Act.

9. Tax rate of export companies and agriculture

   In the first schedule under the tax rate for companies the 14% concessionary rate for exporters and agriculture is granted only if the company is solely engaged in such activity. This is not practical as most if not all exporters and those engaged in agriculture has local sales and in the case of agriculture other trades as well. If the reduced rate is granted for those who are solely engaged in these trades then all those who have a mixed bag have to unwind the other activities including the transfer of employees and assets etc. Hence, the Act should be amended to grant the reduce tax rate even if these companies have other activities in addition to exports and agriculture.

10. Limit on deduction of interest and other Finance Cost

According to this section, the amount of financial costs deducted in calculating a foreign controlled resident entity's income, other than a financial institution, from conducting a business or investment for a year of assessment should not exceed a specified sum.

We note that the above section restricts interest deductions as per a defined formula. In a situation where greater than non-resident persons hold 50% of equity shares of a Sri Lankan company the full interest cost might not be tax deductible even if the interest is paid to a bank that is not an associate company of the non-resident company.

Example- If Company A (non-resident company) holds 51 % shares of Company B (a resident company in Sri Lanka) then if Company B has borrowed from a Bank which is not an associate company of Company A, the interest paid to the Bank would be subject to tax deduction restrictions as per the formula given.

A + (30% *B)

A = is the financial gains derived by the entity that are to be included in calculating the entity's income from the business or investment for the Y/A; and

B = is the entity 's income for the year from the Business or investment calculated without including financial gains derived or deducting financial costs incurred by the entity.

This provision would have far reaching implications for all foreign owned BOI and other entities in the apparel and other sectors including infrastructure. It may in fact be a deterrent to FDI's in the future. We suggest that the interest restriction is applicable only if the interest is paid to the foreign investor or its associates.

11. Gratuity

Currently the gratuity paid under the Gratuity Act is taxable at a concessionary rate of a maximum of 15%. In the new Act gratuity is treated as normal income from employment and is taxable at the highest rate of 24% depending on the slabs. If the government has taken a policy decision to do so, there could be adverse political consequences.

12. Losses from a Business or investment

In subsection 3 it states that:

a) Setting off a business loss against other business profits

Where a person has incurred a loss in business activity and if the loss was a profit and it was taxable then the loss could be set off against such profits or against a profit that is taxed at a reduced rate.

The section states that the loss should be set off against exempt profits as well. While we agree that the loss should be deductible against profits taxable at similar rates or lower rates the requirement to deduct a loss from business income, which is exempt, is flawed since such income is not taxable in any event.

b) Setting off Investment Losses

We note that a loss arising from one investment asset is not deductible against a gain arising from another investment asset. Further we note as per the proposed Act, Capital Gains tax has to be paid and a return has to be filed within a month of the transaction. Therefore, even on a similar investment asset if two transactions take place within a single year of assessment, the capital gains in a preceding period cannot be set off against capital loss that takes place later.

This section should be amended to permit the set off of a capital loss on an investment asset against any gains on investment assets irrespective of the type of capital asset, together with carry forward provisions for any unrelieved investment losses.

13. Long Term Contracts

The taxation of long-term contracts should however follow the basis of accounting as per the accounting standards. Any diversion to a proportionate basis requires estimation for costs and percentage completion etc., which is not a transparent process.

Moreover, it moves away from the concept of simplification, if businesses have to start creating a separate set of financials for such estimation purposes since unlike investment assets/liabilities, these are ongoing businesses with the resulting complexities.

14. Section 35- Tax Avoidance Schemes

As per the proposed law, if a transaction has been entered into and the dominant purpose is to reduce tax liability, then it can be disregarded by CGIR. As per the proposed new law - all tax planning would end up in litigation. We advise that the principles of the present law be maintained with same being possible only if the scheme is artificial or fictitious.

15. Section 36 - Calculation of Gains and Losses

This section provides that the gain of a person from the realization of an asset or liability is the amount by which the sum of the consideration received for the asset or liability exceeds the cost of the asset or liability at the time of realization. If it falls other way around, it is a loss that can be set off against the gain.

It is not clear whether such gain represents a capital gain or falls within business or investment and the treatment of loss, if final position results in a loss.

16. Section 39 - Realisation

Section 39 (b) states that an individual is treated as realising all of the person's assets immediately before death. The deceased is deemed to be receiving market value for all his assets at the time of death. The gain arising on the assets at death would be treated as income from investment assets and would be subject to a tax of 10%.

Budget 2017 proposed the introduction of Capital Gains tax, but the above is in the nature of Inheritance Tax where a tax is deemed, although in essence no transaction has taken place other than the death of a person.

17. Section 49 - Transfer by way of Security, Finance Lease or Instalment Sale

According to this section, if an asset is leased under a finance lease, the lessor is treated as transferring ownership of the asset to the lessee. This treatment is welcome; however according to this section when the lessor transfers the asset to the lessee the transfer is taxable at the market value and the lessee could treat this value as his cost. This arrangement is not practical since in Sri Lanka the full market value is not leased due to risk assessment and also due to government regulations pertaining to loan to asset ratios. Hence, the reference to 'market value' should be removed.

18. Section 50 - Registration of Transfer of Capital Assets

This section prohibits any authorized person registering for a transfer of a capital asset, unless that authorized person is satisfied that the due taxes have been made to the Department of Inland Revenue by the seller. The registration of an asset on transfer is to ensure that the buyer is registered as the owner when the consideration is transferred between the seller and the buyer.

Therefore, we are of the view, prohibiting the transaction to be registered by an authorized person, is flawed by law. If necessary it could be required that such authorized person is required to inform CGIR within a reasonable period of time after such transaction is registered.

Moreover, the liability would be on the seller while the non-registration impacts the buyer. Therefore, it is not an equitable solution.

19. Section 67 - Insurance Business (General and Life)

The new Act requires life insurance companies to pay income tax on investment income earned, less expenses solely linked to generating such income. If this proposal is adopted, life insurance companies would pay a significant amount of tax, as none of the expenses related to running the insurance business would be allowed for tax purposes, e.g., agency commissions, staff salaries, rent, utility costs, etc. The Insurance Association of Sri Lanka (IASL) has already submitted a proposal to tax profits of life companies similar to any other business.

20. Section 90 – Payment of Tax by Quarterly Assessment

Quarterly self-assessment payments –Method proposed in section 90 of the new is not practical.

The current method of the option to use the previous year base should be allowed, with the difference settled with the final payment and section 173 (3) proviso of the current act, where the tax payer is not assessed for using this method has been removed from the new Act, which should be included.

21. Section 93 - Return of Income

This section states every person needs to file a return from a realization of an investment asset with the CGIR not later than one month after the realisation of this asset.

If the intention of the proposed Act is to simplify the taxation process we suggest that we do not introduce the requirement to file ad-hoc returns such as that given above. Gains on investments could also be filed with the annual income tax return.

22. Section 103 – Regulation

Section 97(b) of the Act enables the Schedules to the Act or any monetary amounts specified in the Act to be amended by Regulations made by the Minister. Since the Schedules deal with a very fundamental aspect of the tax viz. the rates of tax, this is an exercise of legislative powers by the executive, which is a violation of the Constitution of the Republic that has a concept of separation of powers.

23. Section 103 – Interpretation

(i) Definition of a "Company" is as follows;

(a) A corporation, unincorporated association or body of a person which includes a friendly society, building society pension fund, provident funds, retirement funds, superannuation funds or society, and

(b) A government, a political subdivision of a government or a public international organization.

As per the above definition even unincorporated associations are treated as companies that includes provident funds and pension funds. This would be a change in the current policy framework and could have negative social implications in the country, since provident funds and retirement funds are subject to income tax at a lower rate.

(ii) Definition of the word "enterprise" is used in section 103 – Arm's length price, including other sections, but there is no definition in the interpretation section

(iii) Definition of "Consideration received" for an asset has meaning given in section 38- requires more clarity since the intention of this section is not clear.

(iv) Definition of Associated Persons- in relation to an individual is wide (includes cousins, aunts and uncles, etc.) Hence we suggest that the definition given in the gazette for transfer pricing is included in the Act.

(v) Definition of a business – states that it is a trade, profession vocation or isolated arrangement with a business character however short the duration of the arrangement. The term business is used in definition of business there is a circular reference. It should be of a "commercial nature" rather than "with a business character".

(vi) Definition of Charitable Institution - Further clarity is required as to what is a charitable institution. Is the intention to include companies as well?

(vii) Definition of a financial institution "in any other category of person prescribed by Regulations" (which refers to should be any other institution regulated by the Central

Bank. The discretion should not be granted to the CGIR to issue regulations regarding the definition of financial institutions.

(viii) Definition of Interest - includes guarantees or service fees payable on debt obligations. Clarity is required if a guarantee fee or a service fee charged by banks on arranging project financing, loan syndications etc. would be categorised as interest, expense, since there is a limit to deductibility.

(ix) Definition of final withholding tax

a) For dividends, final withholding tax does not include another resident company. Therefore, if a dividend flows through many companies the same dividend would be subject to income tax and it would be subject to WHT when it flows through to another shareholder.

b) If an individual rents his house to a company that rent would be subject to WHT at 14% and as per section 88 that would be a final tax. However, if the individual rents his house to another individual it would not be subject to WHT but would be liable to tax at 24%. Is this understanding correct?

24. Section 105 - Consequential Amendments and Repeals.

i) Section 105 (1) states that with the introduction of this proposed Act certain tax laws would be amended as per the seventh schedule. The seventh schedule is still not complete and it is imperative that we are kept informed of the Laws before the Bill is presented in parliament.

ii) As per Section 105 (2) a, the Inland Revenue Act No 10 of 2006 is to be repealed. Income tax exemptions granted by the Board of Investment and/or the Strategic Development Projects Act referred to the Inland Revenue Act no 10 of 2006. Therefore, the income tax exemptions referred would need to be incorporated to the proposed Act or it should be made clear that the provisions in that section would not impact the continuity of exemptions already granted by agreement/gazette to projects on or prior to the commencement of the Act

iii) Section 105 2(b) states that it will repeal any other law if it is inconsistent with the provisions of this Act. The laws that are to be repealed should be announced before the bill is presented to Parliament.

iv) Section 105 2 (4) states that the CGIR is given power to withdraw any gazette which is inconsistent and irrelevant. There should be relevant announcements regarding the gazettes that would be changed prior to the implementation of the Act.

It is strongly stressed that there should not be any attempt to withdraw any rights or privileges already granted under the BOI/SDP Laws and encapsulated in formal agreements/gazettes.

25. Section 03 – Rate of Income Tax for Companies

Our understanding of the above section is that the concessionary tax rates of 14% are applicable only if the company solely conducts an agricultural business or the export of goods or services. If a company carries out more than one activity which they are required to by the very nature of their business (e.g. plantation companies), the provisions of this section precludes the company from claiming the concessionary rate on the relevant business. Companies should be entitled to the concessionary rate on the relevant profits and be subject to the standard rate on profits from other activities.

26. Section 2 - Depreciation Allowances

This part of the schedule includes the manner of deducting depreciation allowances on capital assets and the calculation of profits when such assets are disposed of.

The method stipulated for the purpose of calculating such allowances and also the manner of ascertaining profits/loss on the disposal of such an asset appear to be very complicated.

In our view, these provisions may lead all stakeholders into a confusion and dissatisfaction.
We believe that the methodology applied under the Current IR Act will be very convenient and much better.

27. Assessments

Under the current assessment procedure the Assessor must give reasons for rejecting a tax Return. In the new law that section has been removed and an assessor need not give reasons for rejecting a Return. If there is no provision to give reasons by law it will result in the assessors raising arbitrary assessments on the taxpayers.

a) Amended Assessments

There is no direct reference to an additional assessment, but this section provides for an amended assessment. An amendment could lead to an additional payment, however it appears that an assessment could be a non-acceptance of return. There appears to be no provision for communication of reasons for non-acceptance of a return.

28. Section 52 - Appeal from a Decision of the Tax Appeal Commission

Includes certain timelines and procedure in brief with regard to the appeals to the Tax Appeal Commission and also to the Court of Appeal.

As all necessary upated particulars and details regarding such an appeal are included under Tax Appeal Commission Act, though the provisions in the Tax Appeal Commission Act should take precedence (in a conflict), we believe that the taxpayer could mislead from the provisions in this Act.

29. Section 104 – Interpretation of Tax Laws

Manuals, instructions or guidance issued under the hand of the Commissioner General of Inland Revenue are not specified to be used in the interpretation of tax laws. Such materials which are binding on the officers, in our view, will be useful in such interpretations and the inclusion of them as an option under this provisions may be considered.