Guide

to

sources of income

(Inland Revenue Act No 24 of 2017)

Issued by the Inland Revenue Department
Prelude

This set of guides, which explains very briefly the main provisions of the Inland Revenue Act No 24 of 2017 (the Act) which provide the Department’s view point of the legal provisions and guidance to the general public and the tax payers.

It is intended to issue a Manual of Income tax providing comprehensive information and further clarifications once all the pending policy decisions are taken including amendments to the Act (if any). Subject to that, the instructions, clarifications provided in this guide is applicable as the view point of the Department for the application of the Act.

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Chapter 1 - Imposition of Income tax

1.1 Imposition of Income Tax

Charging Provision

The charging provision is found in Chapter I of the Act (specifically, s. 2(1)), and is the central provision from which the rest of the provisions considered as branches. Generally, income tax is payable on: (a) taxable income; and (b) final withholding payments.

The distinction between taxable income and final withholding payments is important for two reasons. First, taxable income and final withholding payments may be subject to different rates of tax. The relevant rates to be applied to taxable income and final withholding payments in order to determine the income tax payable are set out in the First Schedule to the Act. Second, in computing the income tax payable by any person on taxable income for any year of assessment, such person is entitled to deduct tax credits (including any foreign tax credits) allowed to the person for that year of assessment, s. 2(3). In contrast, tax credits may not be deducted against any amount withheld on a final withholding tax payment.

1.2 Types of Persons and Special Industries

1.2.1 Types of Persons

Under the charging provision, income tax is payable by a person. A person is defined as an individual or an entity, and includes an executor, non-governmental organization and charitable institution (s. 195(1)). An entity means a company, partnership or trust, and therefore need not have separate legal personality. A consequence of the definition of person is that individual taxpayers are treated as separate taxable units. Chapter V of the Act sets out specific rules that govern each type of person.

1.2.2 Special Industries

In contrast to Chapter V of the Act (which provides special rules that apply to particular types of persons), Chapter VI of the Act provides special rules that are particular to certain types of activity without particular reference to the type of person conducting the activity. Division I cover petroleum operations, Division II covers financial institutions and insurance entities, and Division III covers non-governmental organizations and charitable institutions.
Chapter 2 - Income Tax Base

2.1. Taxable Income (S.3)

Taxable income of a person is defined in S.3 of the Act, which comprises of four heads of income sources assessable, namely:

(a) assessable income from employment;
(b) assessable income from business;
(c) assessable income from investment; and
(d) assessable income from other sources.

In arriving at taxable income of a year of assessment of an individual or entity, the following deductions shall be made for:

- qualifying payments, and
- reliefs

(As per section 52 of the Act and as provided in the Fifth Schedule)

In addition, only an individual if falls under following categories is entitled to subtract the tax-free threshold in arriving at the taxable income [as per subsections (2) and (3) of section 52]:

- an individual who is resident in Sri Lanka for a year of assessment: the aggregate relief of Rs 500,000 which is referred to in the paragraph 2(a) of Fifth Schedule.
- an individual who is non-resident in Sri Lanka for a year of assessment but is a citizen of Sri Lanka: the aggregate relief of Rs. 500,000 which is referred to in paragraph 2(a) of the Fifth Schedule.

2.2. Assessable income (S.4)

Section 4 clarifies the assessable income and the liability of both a resident person and the non-resident person for a year of assessment from an employment, business, investment or other source, which is equal to-

(a) in the case of a resident person, the person's income from the employment, business, investment or other source for the year of assessment, irrespective of the income source, wherever the source arises (i.e. worldwide basis of taxation); and

(b) in the case of a non-resident person, the person's income from the employment, business, investment or other source for the year of assessment, to the extent that the income arises in or derived from a source in Sri Lanka.
2.3. **Sources of income**

2.3.1. **Employment income (S.5)**

Calculation of an individual's gains and profits from employment for a year of assessment will be described in Chapter 3.

2.3.2. **Business Income**

A person's income from a business for a year of assessment is the person's gains and profits from conducting the business for the year. For more information please refer chapter 4 of this guide.

2.3.3 **Investment Income (S.7)**

A person's income from an investment for a year of assessment is the person's gains and profits from conducting the investment for the year. Please refer Chapter 5 for more details.

2.3.4 **Other income**

A person’s income from other sources for a year of assessment is the person’s gains and profits from any source of any kind, however does not include profits of a casual and non-recurring nature.

The following amounts should be excluded when calculating a person’s gains or profits from investment.

(a) exempt amounts and final withholding payments; and

(b) amounts that are included in calculating the person’s income from an employment, business or investment.

2.4. **General Rules**

2.4.1. **Concept of “Payments”**

The concept of "payment" in the interpretations S. 195 is the central feature in calculating the income tax base. For example, amounts to be included in calculating a person's income are typically described in terms of payments derived. The concept of payment is intended to encompass all manners in which one person may bestow value on another person.

The "payment" means the conferring of value or a benefit in any form by one person on another person and includes –

(a) the transfer by one person of an asset or money to another person or the transfer by another person of a liability to the one person;
(b) the creation by one person of an asset that on creation is owned by another person or the
decrease by one person of a liability owed by another person;
(c) the provision by one person of services to another person; and
(d) the making available of an asset or money owned by one person for use by another
person or the granting of use of such an asset or money to another person;

Accordingly, paragraph (a) of the definition includes not only a transfer of money or an asset but
also the transfer of a liability.

Example 2.1

Mr. Perera owes Company Z RS. 100,000 payable in 1st year. Company Z is a wholly
owned subsidiary of Company Y. In the normal course of his business, Mr. Perera
provides services to Company Y. Instead of paying Mr. Perera for these services,
Company Y agrees to assume responsibility for Mr. Perera's debt to its subsidiary
Company Z. The effective transfer of the liability from Mr. Perera to Company Y is a
payment from Company Y to Mr. Perera, which must be included in calculating Mr.
Perera's income from his business.

Paragraph (b) of the definition includes bestowals of value similar to those in paragraph (a) but
which, for technical legal reasons, may not amount to a transfer.

Example 2.2

Mr. Silva is a lawyer who provides, in the ordinary course of his profession, legal
services to Company Z. Company Z is the owner of an office block. Instead of paying
Mr. Silva for his services in cash, Company Z grants Mr. Silva a lease of an office on
favorable terms. The lease is not owned by Company Z before it is granted to Mr. Silva
and so could not constitute a transfer of the lease. Nevertheless, the granting of the lease
is a "payment" from Company Z to Mr. Silva within the meaning of paragraph (b) of the
definition of the term in S. 195 and Mr. Silva must include its benefit (normally the
market value of the lease) in calculating his income. Similarly, if Company Z was a
construction company and had built an extension on Mr. Silva's home in return for his
legal services, the benefit of the extension would be treated as a payment from Company
Z to Mr. Silva.

Example 2.3

Mr. Sunil runs a grocery store. He borrowed Rs. 100,000 from Mrs. Priyanka. During a
six-month period, Mrs. Priyanka buys Rs. 20,000 worth of groceries from Mr. Sunil.
Instead of paying Mr. Sunil in cash, Mrs. Priyanka releases Rs. 20,000 of the debt owed
by Mr. Sunil, (i.e. the loan amount due is Rs 100,00 and it is reduced to Rs 80,000 with
this release). The release constitutes a payment of Rs 20,000 from Mrs. Priyanka to Mr.
Sunil, which Mr. Sunil must include in calculating his income.
Paragraphs (c) and (d) of the definition similarly broaden the concept of payment to include services and use benefits.

Example 2.4

Mr. Jagath is an executive officer of Company Z. As part of his remuneration package, Company Z provides Mr. Jagath with the use of a car and the services of a driver and a gardener. Mr. Jagath must include these benefits, (i.e. the use of the car and the services), in calculating his income from employment. The benefits will be valued using the rules in S. 27.

2.4.2. Deciding factors of the source

2.4.2.1. Employment, Business or Investment

The taxable income of a person for a year of assessment is the total of that person’s assessable income for the year from "employment", "business", "investment" and "other sources". The terms "employment", "business" and "investment" are defined in S. 195. Generally, employment involves provision of labour for gain, investment involves holding assets for gain and business involves a combination of both. As the business is a combination there are difficulties in clearly defining the boundaries between employment and business on the one hand and business and investment on the other. Any income that does not fall neatly within the definition of "employment", "business" and "investment" will fall into the residual category of "other sources", unless it constitutes "profits of a casual and non-recurring nature", S. 8.

2.4.2.2. Employment or Business –

It is important to properly classify a person as an employee or an independent contractor. The employee will derive income from employment from their activities whereas the contractor will derive income from business. The rules for calculating these types of income are different and, no deductions are permitted in calculating income from employment, section 10(1)(a) since, employees have few expenses, but an independent contractor providing services may have substantial expenses for which relief is granted.

The definition of "business" in S. 195 specifically excludes "employment". Therefore, if an activity amounts to employment it cannot also be a business. The definition of "employment" in S. 195 essentially refers to the general law concept of employment. The definition also clarifies that managers of entities, individuals holding public office, and directors are employees. Past and prospective employment is also employment; as a result, amounts received either before or after employment are required to be included in income.

The concept of "employment" is a developing area of law and causes particular difficulties in classifying the status of persons who are often called "consultants". It is important to properly classify a person as an employee or an independent contractor. The former will derive income from employment from their activities whereas the latter will derive income from business.
The rules for calculating these types of income are different and, in particular, no deductions are permitted in calculating income from employment (s. 10(a)(i)).

This is an appropriate simple rule for employees, who typically have few expenses. An independent contractor providing services may have substantial expenses and as a result, these types of workers are not subject to the deduction prohibition and relief is granted.

The distinction between employee and independent contractor (business) is also incorporated in Sri Lanka's growing network of double tax treaties.

Most substantial employers have bylaws setting out employee rights. As a general rule, persons entitled to the usual rights set out in the bylaws are employees and the IRD requires them to be treated as such. But there will be borderline cases where further investigation into a person's status is required. Investigation is particularly required of persons who are expressed to have the rights set out in the bylaws but their working conditions are inconsistent with those of a typical employee, e.g. they work few or very flexible hours or have the power to delegate their duties to a third party. Investigation is also required of those persons who do not have the rights set out in the bylaws but their working conditions are substantially the same as a typical employee, e.g. they are engaged to perform services under the direction and control of another person.

In these borderline cases, the correct approach is to weigh a series of relevant factors to determine whether on balance a particular person is an employee or not. The factors to be considered are:

(a) **How the work is done.** Independent contractors are told what is required but not how to do it. Employees are subject to instructions as to not only what they are to do but how they are to do it.

(b) **Whose materials and equipment are used.** Independent contractors use their own equipment to perform the task and purchase the materials to complete the task. Employees are provided with equipment and materials.

(c) **Timing of Work.** Independent contractors are told when a job must be completed but within this timeframe set their own hours (and these often do not coincide with those of normal employees). Employees are told when to work. These are typically set hours that are similar for other employees. The typical employee works fulltime.

(d) **Who Does the Work.** Independent contractors may hire third parties to perform the work. Employees have no power to delegate.

(e) **Exclusivity.** Independent contractors work for more than one client and often many. Employees typically have just one job.

(f) **Training.** Independent contractors arrange and pay for their own training. Employers arrange and pay for the training of employees.

(g) **What is Paid For.** Independent contractors are paid to produce a result for hours worked. Employees are paid to attend for a set time, typically by the week or month.
(h) **Continuing Relationship.** Independent contractors have a limited relationship with the contractor, typically determined by the scope of the task. Employees have a continuing relationship with their employer.

(i) **Calculation of Remuneration.** Independent contractors take risk and derive varying returns. Typically, their expenses are not reimbursed and they have an opportunity for profit or loss.

Employees have their proper business expenses reimbursed, their remuneration is a flat amount for time worked and there is no opportunity for additional profit or loss.

No particular factor is determinative. In the vast majority of cases it will be obvious whether a person is an employee or not. The IRD is particularly interested in cases of high paid executives who argue that they are not employees.

Example 2.5

Ms A is engaged by a manufacturing company to design a new software program to support their operations. Under the agreement, she is required to be in the company office every day until the work is completed. The company provides her with general instructions on how the work is to be performed and she meets with a supervisor once a week. She is not permitted to subcontract to the work to any other person. Ms A is paid a guaranteed weekly amount and will receive a bonus if the software is completed to the company’s satisfaction within 3 months. The manufacturing company provides her with any materials she needs to complete the work.

Ms A will be considered to be an employee. She is provided with guidance on how to complete the work; the company provides her with any materials she needs; she is not able to subcontract; she is paid weekly (although with a bonus on satisfactory completion), so there is no risk to her remuneration. Even though the agreement is not lengthy, the weight of the factors suggests that Ms A is an employee.

Example 2.6

Mr. Perera is an Engineer providing consultancy services on constructions to company X. During the year of assessment 2018/2019, he engaged several constructions projects and derived income according the services he provided on the submission of various reports amounting to Rs. 5,000,000. He uses his own computers and equipment’s for these purposes. Moreover, it was revealed that he has provided same type of services to few other companies too.

Here, the matter in dispute is whether the income derived by Mr. Perera from company X constitutes an employment income or business income for the year of assessment 2018/2019.
Since Mr. Perara is doing his work independently by using his own equipment’s in his own time framework without limiting to one client and derived his income according to his service performance, he is not an employee of the Company X.

As it has been decided that income derived by Mr. Perera for the year of assessment 2018/2019 does not falls within the meaning of employment, it becomes his business income as per the concept of dominancy over the sources of income.

2.4.2.3. Business or Investment

The definition of "business" in section 195(1) extends beyond the generic terms "trade", "profession" and "vocation" in two respects. First it includes "isolated arrangement with a business character however short the duration of the arrangement". The second extension to the definition of "business" in section 195(1) is that it includes a past business and a prospective business. So amounts derived or incurred either before or after a business must be accounted for in calculating income. This is explored further at 7.4.1 in the context of start-up costs and 7.4.6.4 in the context of the disposal of depreciable assets.

Before applying the rules that assist in determining a taxpayer’s taxable income, the type of income earned must be characterized. This involves determining whether a person is engaged in sufficient activity to constitute a "business". Two key distinctions to be made here are (1) whether the person is just passively holding assets such that they have an "investment" rather than a "business" or (2) whether the taxpayer is merely engaged in a hobby, which is an activity without a source.

Dealing first with the distinction between business activities and investment, the definition of "investment" is very broad; the holding of any asset (except for an asset being the principal place of residence of an individual, subject to conditions) amounts to an investment if it is not a business. As stated above, a business is defined to include a "trade", must be understood according to its general meaning. As with employment, assessing whether a person is engaged in a trade involves the weighing of the factors that typically indicate such activity to determine whether on balance the person is conducting a trade:

(a) **What is Sold.** If product sold produces no income of itself and cannot be used personally, this points to a trade. So, for example, the purchase of commercial quantities of a product that cannot be used personally would suggest a trade or at least an isolated transaction of a business character.

(b) **Length of Ownership.** Trades often make money through buying and selling assets. Investment involves the holding of assets. Therefore, if an asset is held for a short period of time, this suggests a trade rather than an investment.

(c) **Repetition.** Repetition of transactions suggests a trade.

(d) **Supplementary Work.** Trades often process assets to turn them into saleable products.
(e) **Motivation for Activity.** Trades acquire assets or conclude contracts with the intention of making a profit. Trades do not acquire assets or engage in arrangements for personal reasons such as family support, education, housing etc.

(f) **Motivation for Sale.** Trades typically sell assets for the same reason they acquire them, in order to make a profit. Other possible reasons for the sale of an asset should be considered such as changes in the market, changes in a work situation, family arrangements etc.

No particular factor is determinative in itself. In the vast majority of cases it will be obvious whether a person is conducting a business or not. There will be borderline cases where the taxpayers must use these factors to determine whether they have a business or investment.

A typical example involves the holding of property for rent.

Example 2.7

Mr. Silva, who is resident in Sri Lanka, acquires an office building and the land of it is situated, during 1st year for Rs. 30,000,000. Mr. Silva's activities (passively renting out a property) do not fall within the definition of "business" in S.195, there is no "trade". Mr. Silva intends to hold the property, which will produce an income of itself through the rent. Further, assuming that is Mr. Silva's only office building, there is no repetition. His activities do, however, clearly fall within the definition of "investment" in S.195. At the end of 1st year Mr. Silva must calculate his income from the investment under S. 7.

The situation would be different if Mr. Silva owned and rented out 5 office buildings and managed the properties by a manager and staff. Here the repetition and active engagement of Mr. Silva with the properties would be sufficient to constitute a business of property rental. So, at the end of 1st year Mr. Silva must calculate his income from the business under S. 6.

Similar factors may be relevant in distinguishing business or investment income from hobby activities, which do not have a source. The primary factor in distinguishing income that is taxable from a non-taxed windfall is the taxpayer’s motivation for the activity. Traders acquire assets or conclude contracts with the intention of making a profit. This motivation can be distinguished from activities that are hobbies. Hobby activities are undertaken for personal reasons. Therefore, windfalls from hobby activities are usually non-recurring and casual, the taxpayer is not organized, the windfall is unexpected and unplanned, and there is no compensatory or market element to the activity.
Example 2.8.

Ms A makes pottery for her personal enjoyment. Other than regularly attending at the market, she is not organized, she does not have a strategy to earn a profit, and she has no training in pottery making. Her activities are neither a business nor investment; therefore, she is not able to claim her losses from her crafting activities.

As per the concept of dominancy, just as the definition of "employment" is dominant over the definition of "business", the definition of "business" is dominant over the definition of "investment". So, if an activity amounts to business it cannot also be an investment.

The definition of "investment" is very broad; the holding of any asset (except for an asset being the principal place of residence of an individual, subject to conditions) amounts to an investment, if it is not a business.

Example: 2.9

Mr Anura is carrying out a furniture shop. He purchased a showroom in order to expand his business. Currently, he does not need all the floor space but hopes to require it all in the near future. Mr Anura rented it out the excess floor space to a saloon. Whether this rent falls under the income of business or investment?

There is an effective connection between the rent and the business of Mr Anura because he derives this rent income in conducting the furniture shop. Hence, the rent should be included in calculating Mr Anura's income from his business.

Example: 2.10

Mr Gamage runs a small Internet café and makes profits in excess of his operating capital needs. He puts some of the excess funds on deposit with a bank and derives interest from the deposit. Mr Gamage uses the remainder of the excess in purchasing a residential property. The balance part of the purchase price of the residential property is funded through a Bank loan. Mr Gamage rents out the residential property and pays the bank interest on the Bank loan.

Neither the interest on the bank deposit nor the rent on the residential property received by Mr Gamage is effectively connected with his business. so, it does not constitute a business income.

Example 2.11:

Mr Silva is an employee in a reputed firm and he rents out his own car to a company and earned rent income.

His rent income falls within the meaning of investment {7 (2)(a)} but disposal gain of such car does not falls within the meaning of any sources of income. As it is neither investment assets nor business asset.
In determining whether an amount is from an investment or business, it should be identified the connection with those types of activity. So, if an amount is derived in the context of a business, it is treated as business income irrespective of whether such returns mentioned in s. 7. The s.6(2)(g) also emphasize this idea. That is, investment type returns that are "effectively connected" with a business are treated as business income.

The "effectively connected" test is a question of nexus or association. There are varying degrees of connection and so it is not possible to state concrete rules in this area. Nevertheless, all that is required is an "effective" connection with a business and so a broad approach should be adopted. Just because a business has funds on deposit with a bank does not mean that the interest earned is not effectively connected with the business. The nexus might be broken where the funds are on fixed deposit for 3 years or more. In such a case it is still open to the taxpayer to show that there is an effective connection between the business and the interest derived. (Ceylon Steel Corporation Limited v. Commissioner General of Inland Revenue).

**Prospective Business**

What amounts to be included in a "prospective" business will be a question of fact and degree. The factors considered in determining whether a person conducts a "prospective" business are similar to those considered in determining whether a person conducts a business.

These will include conducting activities on a business-like manner, with the type of activity, expected volume of trade and repetition all being considered. A profit motive is also usually a critical element in conducting a business but it is here that there might be a difference between a prospective business and actually conducting a business. With a business the person will have begun the actual activity by which a profit is expected but with a prospective business this will not be the case. A person may have a prospective business even though the actual business is never conducted.

**Example 2.12**

Mr. Dayan is in the middle of setting up a restaurant and Company Z approaches him. Company Z runs a chain of European cuisine restaurants within Colombo and is concerned that Mr. Dayan might prove to be serious competition in the long run. Company Z offers to purchase Mr. Dayan's prospective business and under the terms of the arrangement Mr. Dayan will agree not to open up a restaurant in Colombo for the next 15 years. Mr. Dayan accepts the offer before the restaurant is opened. Mr. Dayan still has a "prospective" business even though he never actually conducts the business. He may deduct the start-up expenses. Further, any gain he makes on the sale of his prospective business will be treated as income from a business under S. 6(2)(c). This is also true of the payment for the future restriction on his conducting the business, s. 6(2)(e).
Chapter 3 - Employment Income

3.1. What is employment?

Employment involves provision of labour for gain. The definition of "employment" in section 195 essentially refers to the general law concept of employment. This general law concept is extended to include past and prospective employment and so amounts received either before or after employment may be required to be included in income.

"employment" –

(a) means –

i. a position of an individual in the employment of another person;

ii. a position of an individual as manager of an entity;

iii. a position of an individual entitling the individual for a fixed or ascertainable remuneration in respect of services performed;

iv. a public office held by an individual;

v. a position of an individual to whom any payment is made or due by or from an employer or who receives any other benefit as an employee or in a similar capacity;

vi. a position as a corporation or company director; and

(b) includes a past, present or prospective employment.

3.2. Gain and profits (section 5)

3.2.1. Items included

The following benefits received or derived from employment are taxable as income from employment:

- Salary, wages, leave pay, overtime pay, fees, pensions, commissions, gratuities, bonuses, and other similar payments;
- allowance, including any cost of living, subsistence, rent, entertainment or travel allowance;
- Payments providing discharge or reimbursement of expenses incurred by an individual or an associate of the individual;
- Payments for an individual's agreement to conditions of employment;
- Payments or transfers to another person for the benefit of an individual or an associate person of the individual;
- The fair market value of benefits received or derived by virtue of the employment by an individual or an associate person of the individual;

Example 3.2.1.1

Mr. Silva is an executive officer of Company X. As part of his remuneration package, Company X provides Mr. Silva with a car and the services of a driver and a gardener. Mr. Silva must include these benefits (use of the car and the services) in calculating his income from employment under section 5(2)(h) and valued under section 27.

- Other payments, including gifts, received in respect of the employment;
- The market value of shares, at the time they were allotted, under an employee share scheme, including shares allotted as a result of the exercise of an option or right to acquire the shares, excluding the employer’s contribution for such shares;

Example 3.2.1.2

Mr. Perera is employed as a manager of Company Z. During 1st year Mr. Perera receives as part of his remuneration package an option to acquire 1,000 shares in the Company at a price of Rs 500 per share. At the time of receipt, the market value of the options is Rs. 300,000. In the middle of 2nd year Mr. Perera exercises the options by paying Rs. 500,000 and receives 1,000 shares in Company Z. The market value of the shares at the time of allotment to Mr. Perera is Rs. 800,000. The receipt of the options during 1st year is a benefit in-kind but Mr. Perera need not include the value of the options in calculating his income from the employment in 1st year, under section 5(3)(e). However, Mr. Perera will need to include as his assessable income from employment an amount equivalent to the market value of the shares at the time of allotment (i.e. Rs. 800,000), less the consideration paid by Mr. Perera upon exercising the options (i.e. Rs. 500,000), which works out to be Rs. 300,000.

- Payments for redundancy or loss or termination of employment;
- Retirement contributions made to a retirement fund on behalf of the employee and retirement payments received in respect of the employment, other than contributions made by the employer to a pension fund, provident or savings fund/society, approved by the Commissioner General of Inland Revenue.

3.2.2. Items excluded

The following benefits are excluded:

- Benefits identified as exempt and benefits subject to final withholding tax;
- A discharge or reimbursement of expenses incurred by the individual on behalf of the employer;
- A discharge or reimbursement of an individual's dental, medical or health insurance expenses where the benefit is available to all full-time employees on equal terms;
- Payments made to or benefits accruing to employees on a non-discriminatory basis that, by reason of their size, type and frequency, are unreasonable or administratively impracticable for the employer to account for, or to allocate to the individual;
- The value of a right or option to acquire shares at the time such shares are granted to an employee under an employee share scheme.

Related case law
Kanakasabapathy vs CGIR 4 SLTC 140
N. E. Weerasooriya vs CGIR 4 SLTC 82
P. M. Jeyarajan vs CGIR 4 SLTC 257
Shilton vs Wilmshurst 64TC 78

3.2.3. Value of Benefits (section 27)

(a) value specified by the Commissioner General
(b) in any other case according to market value

3.2.4. Deductions

No expenses are deductible in ascertaining employment income in terms of section 10.

3.3. Pre-and post-employment receipts

Almost all amounts that are derived in respect of employment must be included in calculating employment income under section 5. For this purpose, as discuss in following examples, the concept of "employment" itself is very broad and encompasses both "prospective" and "past" employment.

Example 3.3.2.1 – Prospective Employment

Mr. A works for a large accounting firm. Company Z, a rival accounting firm, wishes to recruit Mr. A and they approach him. Mr. A is reluctant so Company Z tries to convince him by giving him a new motorcycle for agreeing to commence employment with them in 3 months. The market turns and by the end of 3 months Company Z no longer wishes to employ Mr. A and so Mr. A stay with his current firm. Mr. A has a prospective employment with Company Z at the time he is given the motorcycle. A prospective employment is an "employment" for the purposes of s. 195(1). Therefore, the value of the motorcycle must be included in calculating Mr. A's income from the employment with Company Z, section 5(2).
Example 3.3.2.2 – Past Employment

Mr. Perera worked for Company A, a firm of engineers, for 30 years until he left their employ last year to pursue his lifelong dream to write a novel. Mr. Perera continues to refer enquiries and acquaintances regarding engineering matters to Company A.

In appreciation for this and all his work over the years, Company A gives Mr. Perera a 3% commission on fees charged to his referrals. Mr. Perera has a past employment with Company A. This is an "employment" for the purposes of section 195(1). Therefore, Mr. Perera must include the commissions in his income from the employment with Company A, under section 5(2).

3.4. Basis of payment

Income from employment of an individual should be account for income tax purpose on cash basis under section 21(2).

Example 3.4.1

Mr. Silva is an employee of ABC Company. The company paid bonus of Rs 500,000 in December 2017. Out of the profit earned for the year of assessment 2016/2017. Mr. Silva is liable to tax on this bonus for the year of assessment 2017/2018 and ABC Company must deduct WHT on this bonus for the month of December 2017.

3.4.1. Withholding by Employer

Section 83 instructs employers to withhold tax from income from employment at the rates specified by the Commissioner General as per First Schedule to the Act. An employer must provide an employee with a withholding tax certificate not later than thirtieth day of April of that year, or where an employment ceases during the year of assessment, not more than 30 days from the date of cease of the employment. The withholding tax certificate must be in the required form and contains pertinent information in relation to the withholding tax affairs of the employee in respect of that employment, including the amount of income received by the employee for that year of assessment and the amount of tax withheld.

A resident individual who only has income from employment that is subject to withholding by employer for a year of assessment will not be required to file a return for that year of assessment, section 94(1)(a)(ii).

3.4.2. Aggregate reliefs referred to in section 52 (schedule 5)

(a) Personal relief of Rs. 500,000 for each year of assessment

This relief is available for resident individuals and for individual who is not resident in Sri Lanka but is a citizen of Sri Lanka
(b) Relief of Rs. 700,000 for each year of assessment
This relief is available for resident individual with income from employment

3.5. Treatment for Retirement Benefits

Profit from employment include certain lump sum receipts of an employee at retirement. These receipts are profits for the year of assessment in which they received. Retirement benefits other than compensation is taxed at lower rates. Compensation is taxed at lower rate if the employer has made such payments in accordance with a scheme, which is uniformly applicable to all his employees. Where the employer does not have a uniformly applicable scheme for the payment of compensation for loss of office, it should be taxed at normal rates.

i. Retiring gratuity
ii. Commuted pension
iii. Compensation for loss of office or employment
iv. Withdrawals from Employees Trust Fund

Lower rates applicable for retirement benefits

(a) where the period of contribution or the period of employment is 20 years or less

<table>
<thead>
<tr>
<th>Total Income from Employment</th>
<th>Tax Payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>On the first Rs. 2,000,000</td>
<td>Nil</td>
</tr>
<tr>
<td>On the next Rs. 1,000,000</td>
<td>5%</td>
</tr>
<tr>
<td>On the balance</td>
<td>10%</td>
</tr>
</tbody>
</table>

(b) where the period of contribution or the period of employment is more than 20 years

<table>
<thead>
<tr>
<th>Total Income from Employment</th>
<th>Tax Payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>On the first Rs. 5,000,000</td>
<td>Nil</td>
</tr>
<tr>
<td>On the next Rs. 1,000,000</td>
<td>5%</td>
</tr>
<tr>
<td>On the balance</td>
<td>10%</td>
</tr>
</tbody>
</table>

3.6. Exemptions relevant to employment income (Third Schedule)

- Compensation or gratuity paid in lieu of personal injuries or death.
- Amounts paid on retirement from any provident fund approved by the Commissioner General of Inland Revenue.
- Amounts paid on retirement from any pension fund or the Employees’ Trust Fund, representing investment income earned for any period commencing on or after 1 April 1987.
- Pension received from the Sri Lankan Government or from a Department of the Government.
- Benefits derived by a government employee, from a road vehicle permit granted to such employee.
- Income derived by an individual entitled to privileges under the Diplomatic Immunities Law and other specified conventions.
- Employment income of expatriate employees (up to a maximum of twenty employees) who are working in a company which has incurred expenses exceeding USD 1,000 Mn on depreciable assets (other than on intangible assets) in Sri Lanka or a state-owned company entitled to an enhanced capital allowance as stated above.

3.7. **Pay – As – You Earn scheme**

Income tax payable by an employee on his employment income under the provisions of this scheme is deducted by the employer at the time of payment or credited. Tax so deducted each month represents the income tax payable by the employee on that part of income.

Employment income is thus taxed, as it is earned, by withholding the tax at source.

3.8. **More than one employment**

3.8.1. **Primary Employment**

Each employee must designate his or her employment, or in the case where the employee has multiple employments, one of his or her employments, as a "primary employment" by providing a declaration to the employer nominating such employment as the employee’s primary employment ("primary employment declaration"). An employee can only have one primary employment at any one time and once nominated, such employment will remain as the employee’s primary employment until expressly withdrawn. Employee also need to provide the withholding tax certificate issued by the former primary employer for that year of assessment. The new primary employer must take into consider the income and tax withheld by former primary employer when calculating the employee’s tax to be withheld for that year of assessment at the appropriate rates in the tax tables specified by the Commissioner General of Inland Revenue.

Where an employee ceases his or her primary employment and commences a new employment within the same year of assessment, the new employer can treat the employment as a primary employment if the employee provides the new employer with a new primary employment declaration and withholding tax certificate(s) issued by the former primary employer(s) in respect of the former primary employment(s) for that year of assessment.
The new primary employer must, for the purposes of calculating tax to be withheld under s. 83, add to the income from the new primary employment for the year of assessment all income from the employee’s former primary employment as well as add to the tax considered to be withheld by the new primary employer all tax withheld by the employee’s former primary employer, based on the information set out in the withholding tax certificate issued by the former primary employer.

### 3.8.2. Secondary Employment(s)

Any employer that is not presented with a primary employment declaration will be treated as a secondary employment must withhold tax on that employee’s income from such secondary employment in accordance with the following:

(a) where the monthly payment to the employee is less than or equal to LKR 50,000 per month, at 10%; or  
(b) where the monthly payment to the employee exceeds LKR 50,000 per month, at 20%.

### 3.9. Employer’s Obligations

i. Deduct income tax from the gross remuneration of the employees, who are liable to pay income tax according to tables provided by the Commissioner General of Inland Revenue.  

ii. Maintain proper records on the specified forms in respect of each employee who is liable tax and remit the taxes deducted in any month on or before the 15th of the following month.  

iii. Furnish annual declaration on or before the 30th of April every year.  

iv. Issue a withholding tax certificate on tax deduction to employees on or before 30th of April immediately succeeding the end of the year of assessment or within 30 days from the cessation of employment if the employee has ceases his employment.
Chapter 4 - Business Income

4.1. What is Business Income?

Business income is defined in the Act as follows

“business”

(a) Includes

i. trade, profession, vocation or isolated arrangement with a business character however short the duration of the arrangement; and

ii. a past, present or prospective business; but

(b) excludes an employment;

According to the above definition, it is important to understand the business in terms of "trade", "profession" and "vocation". These terms must be understood according to its general meaning.

It also includes "isolated arrangement with a business character however short the duration of the arrangement".

Further, the definition of "business" is extended to include a past business and a prospective business. So, amounts derived either before or after a business must be accounted for in calculating income (Prospective business will be discussed in item 4.1.2.)

The definition of business specifically excludes "employment". So, if an activity amounts to employment, it cannot also be a business. Likewise, if an activity amounts to business it cannot also be an investment.

This is because of the concept of dominancy over the sources of income. That is, the definition of "employment" is dominant over the definition of "business" and the definition of "business" is dominant over the definition of "investment".

4.1.1. Trade, Profession and Vocation

4.1.1.1. Trade

The factors to be considered in deciding whether an activity amounts to a trade are mentioned in the chapter 2.4.3

No particular factor is determinative in itself. In the vast majority of cases, it will be obvious whether a person is conducting a business or not. In some circumstances, the existence of one single badge is enough to show trading. In other cases, a combination of the badges of trade need to be looked into. However, these tests have to be applied having regard to the relevant facts and circumstances of each case.
References:
Ruthledge v. CIT (14 TC 490)
Leeming v. Jones (15 TC 33)
Edward v. Bairstow & Harrison (36 TC 207)
Mahawitharane v. CIR (3SLTC 156)
Ram Iswara v. CIR (3 SLTC 241)

4.1.1.2. Profession & Vocation

The Act does not define Profession and Vocation. Both vocation, as well as profession, indicates the career or the occupation through which an individual makes a livelihood, vocation is a broader term than profession. A profession is an occupation that requires extensive training and the study and mastery of specialized knowledge, and usually has a professional association, ethical code and process of certification or licensing. Further they practiced on the basis of relevant professional qualifications in a personal, responsible and professionally independent capacity by those providing intellectual and conceptual services in the interest of the client and the public”. A vocation is an occupation, either professional or voluntary, that is carried out more for its altruistic benefit than for income, which might be regarded as a secondary aspect of the vocation, however beneficial. Vocations can be seen as fulfilling a psychological or spiritual need for the worker, and the term can also be used to describe any occupation for which a person is specifically gifted, in other words born with talents, and usually implies that the worker has a form of "calling" for the task.

4.1.2. Prospective business

As per the definition, “Business” includes prospective business. It is an expanded concept of business. What amounts to a "prospective" business will be a question of fact and degree. The factors considered in determining whether a person conducts a business may applicable to determination of whether a person conducts a "prospective" business. However, when considered the profit motive factor, there might be a difference between a prospective business and an actual business. With an actual business, the person will have begun the actual activity by which a profit is expected but with a prospective business this will not be the case. A person may have a prospective business even though the actual business is never conducted.

Example 4.1.2.1

Ms Rita runs a reputed restaurant and catering business in Colombo and wishes to open a new restaurant in Kandy. Mr John is the market leader for the same type of business in Kandy. He concerned that Ms Rita might prove to be a serious competitor in the long run. Therefore, Mr John offers to purchase Ms Rita's prospective business and under the terms of the arrangement Ms Rita will agree not to open up a restaurant in Kandy for the next 5 years. Ms Rita accepts the offer before the restaurant is opened and she still has a "prospective" business even though has not actually conducted the business. This is also true of the payment for the future restriction on her conducting the business.
The expenses she made for the prospective business can be deducted from such business receipt (payment for the future restriction on her conducting the business). And if she made loss from the prospective business, such loss can be deducted from the profit, if any, from her other business.

4.2. Deciding facts of Business income

There are difficulties in clearly defining the boundaries between employment and business on the one hand and business and investment on the other. This will further explain under chapter 2.4.2.

4.3. Gains and Profits from Business

All gains and profits from conducting the business for the year of assessment has to be taken into account in computing the business income. Section 6 expressly required to include the following items as gains and profits from conducting a business for a year of assessment.

(a) Sale of any goods or article and receipts by providing a service including mixed receipts;
(b) consideration received in respect of trading stock;
(c) from the realisation of capital assets and liabilities of the business as calculated under Chapter IV
(d) amounts required to be included by the Second or Fourth Schedule of the Act on the realisation of the person’s depreciable assets of the business; (will be discussed 4.4.2.4.)
(e) amounts derived as consideration for accepting a restriction on the capacity to conduct the business;
(f) gifts received by the person in respect of the business;

Example 4.3.1

The company ABC is engaged in the business of selling furniture. The company regularly purchase cushions for the manufacturing furniture. The company has been selected as the best purchaser of the cushion manufacturer and therefore, received a small motor lorry as a gift.

(g) amounts derived that are effectively connected with the business and that would otherwise be included in calculating the person’s income from an investment; (eg. Penalties, surcharges or default interest derive by conducting the business, Government grants derived by the business).
(h) other amounts required to be included under this Act.
These will include;

a partner’s share of partnership income to the extent that such partnership income comprises income from a business of the partnership, s. 55(1);

i. gains on disposal of an interest of a partner in a partnership as calculated in accordance with Chapter IV and s. 56, s. 55(2);

ii. amounts derived by a trust to which a beneficiary is presently entitled (see 3.4.1 below) that would otherwise be treated in the hands of the trust as income from a business, s. 57(1);

iii. distributions of a non-resident trust to a beneficiary to the extent that underlying income has not been subject to tax in the hands of the trust or the trustee and the interest is effectively connected with a business of the beneficiary, s. 58(1)(b);

iv. gains on disposal of interest of a beneficiary in a trust where the interest is effectively connected with a business of the beneficiary, s. 58(2);

v. distributions of a non-resident company to a shareholder, where the shares are effective connected with a business of the shareholder, s. 61(1)(b); and

vi. gains on disposal of interest of a shareholder in a company where the interest is effectively connected with a business of the shareholder, s. 61(2).

In calculating a person’s gains and profits from conducting a business for a year of assessment the following shall be excluded:

(a) exempt amounts and final withholding payments; and

(b) amounts that are included in calculating the person’s income from an employment.

4.4. **Deductions**

Deductions will be discussed relevant to the all source of income, generally deduction of the act falls in to three main categories
- General deductions (s.10)
- Main deduction (s.11)
- Other deductions including specific deductions (s.12-s.19)

4.4.1. **General deduction rules**

Section 10 provides general deduction rules in calculating profits and income of a person. Basically, four general rules have been set out in s.10.
i. (a) No deduction shall be made in calculating a person’s income from employment.
(b) Certain specific deductions are not allowable in calculating a person’s income (will be discussed under item no......)
ii. A deduction for a payment shall not be allowed until the tax, if required, withheld has been paid to the Commissioner General.
iii. No deduction shall be allowed except as expressly permitted by the Act.
iv. Where more than one deduction applies, the most specific deduction shall be applied even if that results in the denial of a deduction (Refer Examples 11 and 12).

Section 10 (1)(b)
The Following deductions shall not be made in calculating a person’s income.
1. Domestic expenses (refer item 4.4.1.1)
   i. Tax payable under the Inland Revenue Act. (This includes instalment, interest, penalty, WHT including PAYE tax paid by any employer in respect of the employment income of any employee).
   ii. Interest, penalties and fines payable to a government or a political subdivision of a government of any country for breach of any written law.
   iii. Expenditure incurred on tax exempted income and income relating to the final withholding payments.
Example 4.4.1.1
   Nations’ Bank, licenced commercial bank in Sri Lanka, has invested in sovereign bonds and shares in resident companies. During the Y/A 2018/19, the bank has earned interest income from sovereign bonds and dividend income from shares invested in resident companies. Such business receipts represent the exempted income and final withholding payments respectively.

   Hence, the Bank is not allowed to deduct expense incurred by the Bank to earn such exempt amount and final withholding payments from the profit of the Bank liable to tax.

iv. retirement contributions, If such contribution;
   (a) has not considered as a benefit of an employee; or
   (b) is a contribution made by the employer to a pension, provident or saving fund or to a provident or saving society not approved by Commissioner General?

v. Dividends of a company.

vi. Entertainment expenses and outlays-
   “entertainment” means the provision to any person of food, beverages, tobacco, accommodation, amusement, recreation or hospitality of any kind” (S.195).
vii. Transfers to reserves or provisions for future expenditure or losses which has not incurred during the year of assessment.

viii. Amounts incurred on lotteries, betting or gambling, other than amounts incurred from conducting a business of lotteries, betting or gambling.

ix. Taxes or other levies specified by the Commissioner-General.

4.4.2 Domestic expenses

Section 197 defined the Domestic Expenses as follows.

(A) Where an individual incurs expenditure in respect of himself, the expenditure shall be domestic expenditure to the extent that it is incurred –

i. in maintaining the individual, including in providing shelter as well as meals, refreshment, entertainment or other leisure activities;

ii. in the individual commuting from home;

iii. in acquiring clothing, including shoes, for the individual, other than clothing that is not suitable for wearing outside of work;

iv. in educating the individual, other than education that is directly relevant to a business conducted by the individual and that does not lead to a degree or diploma; or

v. in paying any personal debts, including credit card debts, of the individual.

These are the expenses incurred by a self-employed person on his or her own behalf. So, such expenses contain prohibition on deductibility. However, some expenses contain limited exception to the prohibition. The following examples elaborate such limited exception.

(a) As per item no 1(A)(iii), cost of clothing is not deductible unless it is unsuitable to wear outside of work. So, this rule does not prohibit protective clothing. Ex. The cloak worn by medical practitioners.

Similarly, the rule does not prohibit a deduction for the cost of clothing that forms part of a service provided, such as the costumes worn by performers.

The rule does prohibit only the expenses incurred by self-employed persons for cloths which are suitable to be worn outside of work also.

Ex. Cost of Suits made by Lawyers, Medical Consultants.

(b) Item No.1 (A)(iv) prohibits the deduction for the expenses made by the individual in educating himself. But, it does not prohibit the expenses made for the education that is directly relevant to business conducted by the individual and that does not lead to a degree or diploma.
For example, expense made for the usual type of training taken by professionals to keep up-to-date and which is directly relevant to the business in question is not prohibited.

e.g. the cost of a training course offered to lawyers on recent changes in the law is not prohibited but cost for a course on creative writing is prohibited and so not allowable. Further, a deduction is also denied if the education is part of a course leading to a degree or diploma.

(B) Where another person incurs expenditure in making a payment to or providing any other benefit for an individual, the expenditure shall be domestic expenditure except to the extent that –

i. the payment or benefit is shall include in calculating the income of the individual;
ii. the individual provides consideration of an equal market value for the payment or benefit; or
iii. the amount of the expenditure is so small as to make it unreasonable or administratively impracticable to account for it.

These are the expenses incurred by a person on behalf of an individual’s benefit. Individual’s such benefit constitutes a “payment” from the person who made it and therefore, becomes an expense incurred by such person.

Tax treatments on such expenses with special attention to the above three exceptions are elaborate by following examples.

Example 4.4.2.1

Company A employs Mr Z. It provides Mr Z with private use of a company car and, along with other employees, meals provided on Company A's premises. Both the use of the company car and the provision of the meals are payments from Company A to Mr Z. The use of the company car is included in calculating Mr Z's income from employment under s. 5(3)(h) and valued under s. 27.

Accordingly, because of the exception referred to in item 1(B)i, Company A is not precluded from claiming a deduction for expenses incurred in making the car available to Mr Z, i.e. maintenance expenses.

But, as per s. 5(4)(d), no amount is required to be included in Mr Z's income with respect to the meal benefits. As a result, Company A is not allowable to deduct expense incurred in providing meals to the employees including Mr. Z.
Example 4.4.2.2

Mr A runs a restaurant. He regularly permits members of his family to dine free of charge with his paying customers. The meals provided by Mr A constitute a payment from him to both his paying customers and his family members.

Mr A's paying customers pay market value in consideration for their meals. As a result, Mr A is not precluded from deducting expenses incurred in providing the meals to his paying customers as per item no 1(B) (ii). In the normal course, such expenses would be deductible under s. 11 too.

But, because Mr A's family members do not pay for their meals, Mr A is precluded to deduct expenses incurred in providing meals to his family members.

(C) Expenditure referred to in (A) and (B) shall include interest incurred with respect to money borrowed that is used in a manner referred to in those subsections.

4.4.3 Main deduction rule

Section 11 is the main deduction rule in the Act. The section is critical importance in calculating business income under the Act. This is because no amount is allowed as a deduction in calculating income except as specifically authorized under the Act (S.10(3). Hence, as this section 11 is available in the Act, subject to the conditions specified in the section, expenses of the business or investment can be deductible in ascertaining the income from business or investment.

Section 11 specifies as follows;

“(1) In calculating a person's income from a business or investment for a year of assessment, expenses to the extent they are incurred during the year by the person and in the production of income from the business or investment, shall be deducted.

(2) No deduction shall be allowed under subsection (1) for an expense of a capital nature.

(3) In this section, “expense of a capital nature” includes an expense that secures a benefit capable of lasting longer than twelve months”.

4.4.3.1. Main aspects of the Section 11.

i. Expenses of a capital nature is not allowable.

Under, section 11(2), expenses of a capital nature cannot be deducted. As per section 11(3), “expense of a capital nature” includes an expense that secures a benefit capable of lasting longer than twelve months”.

However, this does not necessarily mean that an expense which secures a benefit lasting twelve months or less is revenue in nature and wise versa.
In determining whether such an expense is revenue or capital in nature, the various tests under case law, such as the fixed or circulating asset test, enduring benefit test and once-and-for-all test, will continue to apply.

Reference:
Van Den Berghs Ltd V clark (19 TC 390)
Barr Crombie & Co Ltd V CIR (26 TC 406)
Short Brothers Ltd V The CIR (12 TC 955)
Vallambrosa Rubber Co Ltd V Farmerb (5TC 529)
Atherton V British Insulated and Helsby Cables Ltd (10 TC155)
Heather V P.E. Consulting Group Ltd (48TC 293)

ii. “Actual cost” are eligible for deduction.
As per section 11, only "actual costs" are eligible for deduction. So it will not permit the deduction of "notional" costs, such as those put to a reserve. This is confirmed by section 10(1)(b)(viii) too.

iii. Possibility of an apportionment. ("to the extent they are incurred").
This means that under section 11, expenses are allowed “to the extent they are incurred”.

Example 4.4.3.1.1
A person who has home office and incurs expenses in common for the business and home must apportion the expenses between business and home. And, only the expense attributable to the business is allowed to deduct under section 11).

iv. Expenses must be incurred “in the production of Income”.
This means the section 11 requires the expenses to be incurred in the production of income from business or investment. Production of income generally refers to the intention to make a profit or gain. But, this does not mean that the business or investment actually be profitable in the year the expense is incurred in order to be eligible for a deduction. What is required is that the costs are incurred as part of the activity that is intended to make the profit or gain.

It is because of this reason; start-up cost of a business is allowed as a deduction under section 11.

v. The section is “Residual” in nature.
The section 11 is “residual” in nature. This means, if another provision of the Act denies a deduction then Section 11 will not permit a deduction. This is because of the operation of section 10(4) of the Act.

“Where more than one deduction applies, the most specific deduction shall be applied even if that results in the denial of a deduction” [10(4)]
Particularly, sections 12 to 19 of the Act are called as specific deduction provision of the Act. Accordingly, if an expense is of a particular kind that is dealt with in one of those sections then, as the more specific provision, that section must be used irrespective of whether the result is the granting or denial of a deduction. In such a circumstance, section 11 has no application and so become “residual”.

**Example 4.4.3.1.2**

Section 11(2) does not permit deductions for capital nature expenses. As per the definition in section 11(3), expense made for acquiring capital asset is a capital nature expense. If a debt obligation has been incurred to acquire such a capital asset, then interest made there on also becomes a capital nature expense. As per section 11(2), such capital nature expenses cannot be deducted.

However, section 12 of the Act deals with the interest deduction. As per the section 12(a), interest on a debt obligation which has been incurred to acquire an asset is deductible if such asset is used during the year in the production of income. Accordingly, even if capital nature expenses denied by section 11, section 12 grant such expenses being the most specific section applicable to interest deduction.

**Example 4.4.3.1.3**

In case of a person who is carrying on a business of hiring vehicles, cost of repairs is an expense incurred in production of income. Hence, such expenses should be considered under section 11. However, Section 14 deals with the expenses for repairs or improvements. Hence, repair expenses can only be deducted subject to the limitation specified in section 14.

Accordingly, even if the section denies the expense (portion of the expense), section 14 is applicable as the most specific section in respect of repairs.

### 4.4.4 Special Deduction rules

#### 4.4.4.1 Interest Expenses

Section 12 and 18 deals with the deductibility of interest.

**Section 12**

i. As per the section 12, the relevant debt obligation should be incurred for following purposes only;

ii. The borrowed money should be used to acquire an asset that is used during the year in the production of income; or and

iii. The borrowed money should be incurred in the production of income.
Example 4.4.4.1.1

Mr. Sunimal is carrying on a business of selling of computer accessories. He obtained a bank loan and utilised the loan proceeds as follows during the year 18/19.

50% for construction of new office building.
25% for payment of salaries to the staff.
25% for his private purposes.

During the year of assessment 2018/2019, he paid Rs. 300,000 as interest for the loan. During the year of assessment 2019/2020 he sold the office building, and Paid the loan interest for the year is Rs. 250,000.

During the year of assessment 2018/2019, under Section 12(a) Mr. Sunimal is entitled for a deduction amounting to Rs. 150,000 (50% of the loan) paid as interest on the funds used to construct the new office building as it is an asset used during the year. Similarly, s. 12 (a) permits a deduction for the interest paid on the funds used to pay the staff salaries amounting to Rs. 75,000 because those funds are used in the production of income from the business. Interest paid amounting to Rs. 75,000 on the funds used for his private purposes is not deductible.

Further, he is not entitled for a deduction of Rs. 125,000 paid as interest on the funds utilized to construct the office building during the year of assessment of 2019/2020 as such building is not used during the relevant year in the production of income for the business.

Section 18

In addition to the section 12, Section 18 is also applicable only for entities on deductibility of interest expense.

Restricts the deductibility of interest deducted in calculating an entity’s income on financial instruments. This is called as thin capitalization rule. The rule is applicable as follows;

For Manufacturing Entities

Allowable Finance Cost attributable to financial instruments = (Total Financial Cost/Total Cost of Financial Instruments) X [(Total of the issued Share Capital and reserves) X 3]

For Other Entities

Allowable Finance Cost attributable to financial instruments = (Total Financial Cost/Total Cost of Financial Instruments) X [(Total of the issued Share Capital and reserves) X 4]

Any deduction unutilized in the current year will may be carried forward up to six years, subject to the same thin capitalization restriction.
This thin capitalization rule does not apply to Financial Institutions.
Example 4.4.4.1.2

Company B is a garment factory and incurs interest expense (for what) amounting to Rs. 2,500,000 during the year of assessment 2018/2019. Balance Sheet of the company as at 31.03.2019 revealed as follows.

- Stated Capital: Rs. 5,000,000
- Revenue Reserves: Rs. 3,000,000
- Long Term Loans: Rs. 30,000,000

Finance Cost attributable to financial instruments = \( \frac{\text{Rs. 2,500,000}}{\text{Rs. 30,000,000}} \times \left( \frac{\text{Rs. 5,000,000}}{} + \frac{\text{Rs. 3,000,000}}{} \right) \times 3 \]

Finance Cost attributable to financial instruments which is allowable to deduct in Y/A 2018/2019 = Rs. 2,000,000.

Balance Rs. 500,000 can be carried forward to Y/A 2019/2020 and so on up to 2025/2026, and deductible subject to the same above basis. That means, the amount of Rs. 500,000/- is added to the financial cost that will be incurred in next year and so on.

4.5 Trading Stock

"Trading stock" is also an asset for a business. Section 197 defines it as "assets owned by a person that are sold or intended to be sold in the ordinary course of a business of the person, work in progress on such assets, inventories of materials to be incorporated into such assets and consumable stores". Further, definitions of "depreciable asset" and "business asset" excluded the trading stocks from such assets. The definition of trading stock incorporates the traditional distinction between circulating assets and fixed assets. Trading stock constituting circulating assets.

This means that the classification of an asset as trading stock or otherwise will differ depending on the nature of the business in which it is held. For example, land held in the context of a business will typically be a "business asset" rather than "trading stock". However, in the hands of a property developer, land will constitute trading stock.

Generally, s. 13 delays a deduction for the cost of trading stock until it is disposed of. Section 13 also provides rules for determining the cost of trading stock and such rules are follows the generally accepted accounting principles.

4.6 Research and Development

Research and development defines in section 15 as follows;

"research and development expenses” means expenses incurred by the person in –

(a) carrying on any scientific, industrial, agricultural or any other research for the upgrading of the person’s business through any institution in Sri Lanka (or for any innovation or research relating to high value agricultural products, by the person or through any research institution in Sri Lanka); or
(b) the process of developing the person’s business and improving business products or process which shall be beneficial to Sri Lanka,

but shall exclude expenses incurred that are otherwise included in the cost of an asset under this Act.

The section 15 is one of the specific section of the Act. The special feature of the section is that it permits the research and development cost even if it a capital nature expense. However, it does not allow to deduct the cost of purchasing of equipment used for the research. But, the section allows the cost of the assets like intellectual property that is created by the research and development.

Further, under sixth schedule, a person is entitled for an additional deduction which is equal to the 100% of the total amount of research and development expenses for three years after 01.04.2018 as a temporary concession and it will expire 31.03.2021.

Example 4.6.1

Company A formed during year 2018/2019 for the purposes of researching and developing a new fertilizer. The research and development is a two-year process. During year 1, Company A incurs expenses in developing the new fertilizer of LKR 5,000,000, including wages for researchers, the rental of a laboratory, legal fees and materials. However, the research for this year is unsuccessful.

Company A is allowed to deduct LKR 5,000,000 expenses incurred during year 1 as these expenses fall within the definition of "research and development costs" in s. 15.

During year 2, the Company spends a further LKR 10,000,000 in research and development costs and this time the research is successful. It has its research patented. The cost of the patent is Rs. 10,000,000/-. It is the intellectual property that is created by the research and development. Hence, that cost can be deducted under section 15.

However, even though, it becomes depreciable asset of the company, depreciable allowance cannot be claimed for the second year as cost of assets has been allowed to deduct for the second year During year 2 the Company sells a permanent exclusive license to use the patent in India to Taj Industries for LKR 20,000,000.

4.7 Agricultural start up expense

For any kind of business, start-up expense is allowable to deduct under section 11. But, under section 11, capital nature expenditure included in start-up expense is not deductible. But, section 15, as the most specific section, is applicable on agricultural start-up expenses and as such, even capital nature expenses included in agricultural start up expenditure is deductible.
4.8 Depreciation allowances and balancing allowances

As per section 16, depreciation allowances and balancing allowances are allowed to be deducted in calculating a person’s income from a business only-

Depreciation allowance are-

(a) granted in respect of depreciable assets owned and used by a person at the end of a year of assessment in the production of the person’s income from a business; and

(b) calculated in accordance with the provisions of the Second or Fourth Schedule to this Act.

Depreciable asset is defined as

“an asset to the extent to which it is employed in the production of income from a business and which is likely to lose value because of wear and tear, obsolescence or the passing of time; but excludes goodwill, an interest in land, a membership interest in an entity and trading stock.”

Accordingly, following conditions has to be considered in respect of the depreciable asset, when claiming the depreciation allowances.

- Ownership of the assets should be available to the relevant person -Legal ownership or ownership of the asset in any other way as specified in the Act.
  
  As per S.49(2), lessee has the ownership of assets obtained on finance lease.

- Used by the person for production of income.

- If any depreciable asset is entitled for a deduction of depreciation allowance, then such claimable cannot be differed for future periods.

Please refer chapter 5 for more information.

According to the fourth schedule to the Act, following should be considered in calculating the depreciation allowance.

1. Straight line method and following formula should be used.

   
   Depreciation allowance = A/B

   
   A - Depreciation basis of the asset at the end of year of Assessment.

   
   B - Number of years relevant to each depreciable asset

2. Full Depreciation allowances will be granted for the year of acquisition if such depreciable assets used up to the end of the year of assessment. No depreciation allowance will be granted for the year of disposal as such asset is not exists at the end of the year of assessment.
3. No depreciation is allowed on road vehicle.
   “Road vehicle” does not include
   i. a Commercial vehicle
      Commercial vehicle means a road vehicle designed to carry loads of more than one or more than 13 passengers or vehicle used in transportation or vehicle rental business
   ii. a bus or minibus
   iii. a goods vehicle
   iv. a heavy general purpose or specialised truck or trailer.

4. Depreciation basis of a depreciable asset shall be the sum of
   i. Depreciable basis (written down value) of the asset at the end of the previous Year of Assessment; and
   ii. Amounts added to the depreciation basis of the asset during the year of assessment in respect of additions to the cost of asset.

Example 4.8.1

The ABC is a garment factory. It acquired a machinery in 01.06.2018 at a cost of Rs. 1,000,000/- and used it in the production of income. Suppose it continually use it for next five years, the depreciation allowance is calculated as follows:

<table>
<thead>
<tr>
<th>Year of Assessment</th>
<th>Depreciation basis</th>
<th>No of Years</th>
<th>Depreciation for the year</th>
<th>Cumulative Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018/2019</td>
<td>1,000,000</td>
<td>5</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>2019/2020</td>
<td>800,000</td>
<td>4</td>
<td>200,000</td>
<td>400,000</td>
</tr>
<tr>
<td>2020/2021</td>
<td>600,000</td>
<td>3</td>
<td>200,000</td>
<td>600,000</td>
</tr>
<tr>
<td>2021/2022</td>
<td>400,000</td>
<td>2</td>
<td>200,000</td>
<td>800,000</td>
</tr>
<tr>
<td>2023/2024</td>
<td>200,000</td>
<td>1</td>
<td>200,000</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

Balancing allowances

*Where a depreciable asset of a person is realized by the person before the end of a year of assessment, balancing allowance is calculated as follows.*

**Balancing allowances (Disposable Loss)**

Balancing allowances = \{written down value of the asset - consideration received for the asset\}

When realizing a depreciable asset, where consideration received exceeds the written down value, it is called as assessable charges (Disposal profit) and taxable as a business receipt.

**Assessable charges (Disposable profit)**
Assessable charges forms part of the person’s business income and will be calculated in accordance with the following formula:
Assessable charges = \{consideration received for the asset - written down value of the asset\}
4.9 Repairs and Improvements

Section 14 is a specific provision applicable for the deductibility of expenditure on repairs and improvements. This means that if an expense falls within the scope of s. 14 then the expense may only be deducted as provided for by s. 14 and not under the general deduction rule in s. 11.

Conceptually, repairs do not improve the value of an asset but only maintain it. By contrast, improvements enhance the value of an asset. It may be difficult to draw a distinction between repairs and improvements therefore Section 14 makes drawing this distinction irrelevant. It can be deducted both repairs and improvements but subject to the limitation in s. 14(2).

Limitation of the deductions

- On Buildings, structures and similar depreciable assets (Class 4)

  The deductions shall not exceed five percent (5%) of the written down value of the asset at the end of the previous year or actual repairs and improvement expenses incurred during the YA which ever less.

- On all other depreciable assets.

  The deductions shall not exceed twenty percent (20%) of the written down value of the asset at the end of the previous year or actual repairs and improvement expenses incurred during the Y/A whichever less.

The residual of repairs and improvement expense for which a deduction shall not be allowed as a result of the limitation shall be added to the depreciation basis of the asset.

Example 4.9.1

Consider the above example 15 and it will be required a repair amounting to Rs.400,000/- in the Year of Assessment 2020/2021.

The repair expense and depreciation allowance deductible under section 14 and 16 respectively is as follows;

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>During the year of assessment 2020/2021, Cost of repair</td>
<td>400,000</td>
</tr>
<tr>
<td>Written down value of the Asset as at the end of previous year</td>
<td>800,000</td>
</tr>
<tr>
<td>Allowable repair cost (800,000 *20%)</td>
<td>160,000</td>
</tr>
<tr>
<td>Excess repair cost to be added to the depreciable basis</td>
<td>240,000</td>
</tr>
</tbody>
</table>
Depreciation allowance to be granted for the remaining Years of Assessment

<table>
<thead>
<tr>
<th>Year of Assessment</th>
<th>Depreciation basis</th>
<th>No of Years</th>
<th>Depreciation for the year</th>
<th>Cumulative Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018/2019</td>
<td>1,000,000</td>
<td>5</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>2019/2020</td>
<td>800,000</td>
<td>4</td>
<td>200,000</td>
<td>400,000</td>
</tr>
<tr>
<td>2020/2021</td>
<td>600,000</td>
<td>3</td>
<td>200,000</td>
<td>600,000</td>
</tr>
<tr>
<td>2021/2022</td>
<td>640,000</td>
<td>2</td>
<td>320,000</td>
<td>920,000</td>
</tr>
<tr>
<td>2023/2024</td>
<td>320,000</td>
<td>1</td>
<td>320,000</td>
<td>1,240,000</td>
</tr>
</tbody>
</table>

Accordingly, Repair and improvement expense made after the expiration of the no of years (in this case 5 years) will not be allowed as value for depreciation basis and number of years are zero.

4.10 Losses

Section 17 provides the deduction of loss from the realization of asset and liabilities in calculating the person’s income from business.

The assets and liabilities are-

(a) Capital assets of a business to the extent to which the assets were used in the production of income from business. (exclude the personal usage)

(b) In the case of a liability that is a debt obligation incurred in borrowing money, the money was used or an asset purchased with the money was used in the production of income from the business.

(c) In the case of any other liability, the liability was incurred in the production of income from the business.

Section 19

Section 19 provides the deduction of loss in calculating the person’s income from business or investment. Two types of losses may be incurred in the context of business or investment.

i. The loss on the disposal of an asset or liability of a business or investment.

ii. Overall loss of a business or investment.

With respect of first type of loss, treatment on disposal will depend on the type of asset in question. That is, if asset in question is either trading stock or depreciable assets or capital assets of a business, loss of disposal falls within the second type of business.

Loss deduction rules.

1. (a) An unrelieved loss of the person for the year from a business can be deducted from any other business of that person.
(b) An unrelieved loss of the person for any of the previous six years of assessment from the business or any other business.

As per section 19 (6)“loss” of a person for a year of assessment from a business or investment shall be calculated as the excess of amounts deducted in accordance with this Act (other than under this section or subsection (5) of section 25) in calculating the person’s income from the business or investment over amounts included in calculating that income; and“unrelieved loss” means the amount of a loss that has not been deducted in calculating a person’s income under this section or subsection (5) of section 25.

Accordingly, only the loss calculated under the Act, No. 24 of 2017 can be deducted under section 19. That means a transitional provision need to be incorporated to the Act to treat the brought forward loss under the Inland Revenue Act, No.10 of 2006.

2. An unrelieved loss which is eligible to deduct for a Year of Assessment cannot be deferred to another year of Assessment.
3. Reduced rate loss can be deducted only from same reduced rate or lower reduced rate or exempt profit.
4. The above deduction rules apply on treatment of investment losses other than the losses from disposal of investment assets.
   (a) An unrelieved loss from a business may be deducted in calculating the income from business.
   (b) An unrelieved loss from investment can be deducted only in calculating the income from investment.
5. Gain from realization of an investment asset shall not be deducted by any loss on the disposal of another investment asset.

4.11 Other deductions in the Act

1. A Person other than a person conducting banking business can write-off debt claim as bad debt if such person has taken reasonable steps to recovery and the person reasonably believe that recovery is not possible (S.24).
2. A person conducting banking business can make specific provision for bad debt as per the directives made by Central Bank of Sri Lanka and but deductible amount from such provision will be specified by the Commissioner General (s.66).
3. A non-resident person carrying on business in Sri Lanka through a Sri Lankan permanent establishment can deduct head office expense not exceeding 10% of person’s assessable income. Where such expense is exceeding 10% of person’s assessable income, no deduction is available (S.79).
Chapter 5 - Capital allowances and balancing allowances

5.1. Relevant provisions

Section 16 permits a deduction for the capital allowances and balancing allowances granted under the Second or Fourth Schedule in calculating a person’s income from a business.

When calculating a person’s income from a business for a year of assessment;
(a) the capital allowances; and
(b) the balancing allowances,
shall be deducted;

5.2. Capital allowances

A person is entitled to claim capital allowances if such person;
(i) Is the owner of the depreciable asset; and
(ii) Uses them at the end of a year of assessment in the production of the person’s income from a business;
(iii) If the asset is partly used in the production of income from a business, the cost and consideration received for the asset shall be apportioned according to the market value of that part of the asset that is used in the production of income from that business. Please refer No.02 fourth schedule of the Act

As defined in section 195
“depreciable asset”
(a) means an asset to the extent to which it is employed in the production of income from a business and which is likely to lose value because of wear and tear, obsolescence or the passing of time; but
(b) excludes goodwill, an interest in land, a membership interest in an entity and trading stock;

Capital allowances –
- for each depreciable asset shall be calculated according to the straight-line method
- are calculated in accordance with the provisions of the Second or Fourth Schedule to the Act.
- which are granted with respect to a particular year of assessment shall be taken in that year and shall not be deferred to a later year of assessment.
- shall not be granted to a person in respect of a road vehicles, other than –
  (a) a commercial vehicle (“commercial vehicle” means a road vehicle designed to carry loads of more than half a tonne or more than 13 passengers; or a vehicle used in a transportation or vehicle rental business.)
  (b) bus or minibus;
  (c) a goods vehicle; or
  (d) a heavy general purpose or specialised truck or trailer;
Even though the road vehicles are fallen within the depreciable asset. (Please refer No 4 of fourth schedule)

5.3. Calculation of capital allowance

Formula for Calculating capital allowance

\[ \frac{A}{B} \]

A - the depreciation basis of asset at the end of the year of assessment  
B - number of years (please see table 01 which is provided in the item (3) of Fourth Schedule)

Depreciation basis is the sum of –

(a) the depreciation basis of the asset at the end of the previous year of assessment and,  
(b) amounts added to the depreciation basis of the asset during the year of assessment including the excess expense of repair and improvements referred to in section 14 for which a deduction shall not be allowed as a result of the limitation.

For the purpose of calculating the capital allowances, the depreciable assets which have been distinguished between 5 classes of assets and the number of years applicable to relevant depreciable asset which have been stated in Fourth Schedule, have been incorporated for the easy reference as follows.

Table 1

<table>
<thead>
<tr>
<th>Class</th>
<th>Depreciable Assets</th>
<th>Number of Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>computers and data handling equipment together with peripheral devices</td>
<td>5</td>
</tr>
<tr>
<td>2</td>
<td>buses and minibuses, goods vehicles; construction and earthmoving equipment, heavy general purpose or specialized trucks, trailers and trailer-mounted containers; plant and machinery used in manufacturing</td>
<td>5</td>
</tr>
<tr>
<td>3</td>
<td>railroad cars, locomotives, and equipment; vessels, barges, tugs, and similar water transportation equipment; aircraft; specialized public utility plant, equipment, and machinery; office furniture, fixtures, and equipment; any depreciable asset not included in another class</td>
<td>5</td>
</tr>
<tr>
<td>4</td>
<td>buildings, structures and similar works of a permanent nature</td>
<td>20</td>
</tr>
<tr>
<td>5</td>
<td>intangible assets, excluding goodwill</td>
<td>The actual useful life of the intangible asset, or where the intangible asset has an indefinite useful life, 20.</td>
</tr>
</tbody>
</table>
5.4. **Balancing allowances**

Balancing allowances are –

(a) made in respect of depreciable assets
   i. realized during a year of assessment; and
   ii. in respect of which depreciation allowances have been granted in that year or an earlier year; and
(b) calculated in accordance with the provisions of the Second or Fourth Schedule to this Act.

5.5. **Basic Concepts**

i. **Identification of the income source**

Capital allowances are granted in the production of the person’s income from a business. Therefore, it is necessary to determine first whether the taxpayer is conducting a business or an investment.

In order to classify an asset properly, identifying the source of income may have an impact on not only how the asset is classified but also how the asset is identified.

**Scenario 1**

Mr A, acquires an office building with the land. He engages a property manager to rent out the offices in return for 7% of the gross rent received. Assuming this is Mr A's only office building, there is no repetition and he is not actively engaged with the property, he has engaged a manager. Hence his activities do not fall within the definition of "business" in s. 195; there is no "trade". Mr A intends to hold the property, which will produce an income of itself through the rent. His activities clearly fall within the definition of "investment" in s. 195. At the end of the year of assessment Mr. A must calculates his income from the investment under s. 7.

**Scenario 2**

Mr A owned and rented out 5 office buildings and managed the properties himself. Here the repetition and active engagement of Mr A with the properties would be sufficient to constitute a business of property rental. So, at the end of the year of assessment Mr A must calculate his income from the business under s. 6.

Since Mr. A is conducting an investment the land and building owned by Mr A would be considered a single asset. An asset can only be a depreciable asset to the extent that it is used in the production of income from a *business*, therefore this office is not a depreciable asset.

In the 2nd scenario, Mr A is conducting a business. Here the offices are used in the production of income from the rental business, i.e. the rent, which is not a final withholding payment under s. 88(1)(c).
The building is therefore a depreciable asset and must be classified under class 4 assets. Accordingly, the office building will fall into Class 4 and such buildings must be separate from the other buildings of Mr A's business.

A separation will only be required of the land and building if the building is a "depreciable asset" under s. 195. the land is not a depreciable asset as defined. But, as it is used in the business, the land will be a "capital asset", under s. 195. So despite typically constituting a single asset, the Act requires a separation of the land and the building for tax purposes.

5.6. **Classifying the depreciable Asset**

The classes of asset mentioned in the above table 1 [paragraph 1(1) of the Fourth Schedule] are very broad and therefore it will be difficult to identify the relevant class which an asset belongs to.

In such cases, a two-step analysis should be made in classifying the asset.

(i) consider the wording of the various classes outlined in the above Table 1 and determine on a fair reading which class the asset falls into.

(ii) if it is still not clear, determine number of years applicable to a depreciable asset mentioned in Table 1 (paragraph 2(3) of the Fourth Schedule) based on the useful life of the asset and the useful life of similar assets that do clearly fall within a particular class, which the asset most fairly belongs in.

If the analysis is still unclear, then the asset falls into the residual category of "any depreciable asset not included in another Class", i.e. Class 3.

**Example 5.6.1**

Company A runs a business that involves the application of plastics and other chemical compounds to various solid surfaces. It recently had a special "room" installed in part of its factory. The plastics are applied to solid surfaces in the "room" under heavily controlled conditions as to moisture and temperature and to keep contaminates out.

The "room" incorporates various fans, elements and computer controls in order to control the environment in the "room". The "room" may be easily relocated between different parts of the factory but once in place it is loosely fixed to the floor.

In determining which class of depreciable asset, the "room" belongs to, Company A should follow the steps mentioned above.

The "room" possibly falls to be classified as a "structure" under Class 4, a "fixture" under Class 3 or “any depreciable asset not included in another class” under Class 3.

As the wording does not provide a clear answer to this classification, Company A should consider the number of years which have been incorporated to above Table 1, the useful life of the asset and make an analogy with similar types of assets.
With daily use, the "room" is expected to have a useful life of 20 years. By this time the fan and other control devices should be worn out and the computing system obsolete. The frame of the room may still be useable but it would be more cost efficient to replace the entire "room" at this stage rather than try to replace constituent parts. The analysis makes it clear that the number of years provided for Class 4 assets is inappropriate.

Further, the analysis makes it clear that while the "room" may be a "structure" it is not a structure "of a permanent nature" in a way consistent with the number of years provided and the useful life of other assets likely to fall within Class 4.

Company A's "room" is effectively an item of plant or machinery with and through which Company A conducts its business. It correctly falls for classification residually as a Class 3 asset.

If it is uncertain about the proper classification of a particular asset a private ruling can be applied under s. 107

5.7. Special cases

i. Capital allowance for a depreciable asset which is received as a gift

If a depreciable asset is received as a gift in respect of a business the asset will have a cost equal to the amount included in income by reason of s. 6(2)(f), this amount will be included to the relevant class of depreciable assets and capital allowances can be granted.

ii. Capital allowances for an asset that is in temporary disuse.

With respect to granting capital allowances, the asset must be “owned and used” by the person during the year. It is rare that a person does not use the depreciable asset at any time during a year unless it is in need of repair or has become obsolete. It can be considered that assets in need of repair continue to be treated as depreciable assets and used in the business until the asset has truly become obsolete and the person disposes of it because repair of assets is a natural part of a business.

Example 5.7.1

One of the printing machines of Company A is broken down and the Company has had substantial problem of getting it repaired because they had to order parts from the European manufacturer. Hence the Company A had to wait 14 months. Despite the 14 months during which the printing machine was not in use, Company A was actively pursuing its repair and did succeed in having the machine put back into operation. Company A may continue to claim capital allowances during the time it took to have the printing machine repaired.
Example 5.7.2

One of the plant of Company B is also broken down. It could still be used for minor jobs but Company B effectively discarded it when it bought a new plant as a replacement. At this point Company B put the old plant outside its factory under a loose cover. Within a year the old plant deteriorated to such an extent that it could not be used at all.
In the course of a general clean up, Company B later dumped the plant at a landfill site. From a tax perspective, at the point Company B discarded the plant and put it outside Company B is treated as having disposed of the plant under s. 39(e).

04.01.2019 Plant broken down - 2018/2019 can claim capital allowance
06.07.2019 Bought a new machine and machine A discarded – 2019/2020 not entitled to claim capital allowances
10.04.2020 Dumped the plant – 2020/2021 not entitled to claim capital allowances

iii. Capital allowance for Tangible Assets that take some years to construct or grow

Another area worthy of consideration is the treatment of depreciable assets that take some years to construct or grow. The cost of the asset will only be added to the relevant class of depreciable assets once it is "used" in the production of income. So, until the assets are placed in active production, no capital allowance can be claimed.

Example 5.7.3

Company A acquired land and incurred substantial costs planting it with tea. The tea plants will not come into production for 3 to 4 years and they have a limited useful life, typically about 50 years. The tea plants constitute depreciable assets for tax purposes under s. 195.

Accordingly;

i. Overhead costs that are not directly attributable to bringing the plants to maturity would be deductible under general principles.

ii. Costs that are related to bringing the plants to maturity, such as fertilizer, water and the wages of persons tending the plants, must be capitalized in the cost of the plants and so no deduction is available.

iii. Amounts that are not immediately deductible will be included to the cost of the tea plants for tax purposes according to s. 37(1).

iv. When the plants are put into production then these amounts can be categorized under Company A's Class 3 of depreciable assets and capital allowance can be granted.
Example 5.7.4

Company A runs a hotel. It commissioned Company Z to construct a new hotel in Colombo. The contract price is Rs. 20,000,000 and the construction period is two and a half years.

Company A is required to pay the contract price in instalments as follows,
- deposit - 10%,
- after the foundations are laid - 20%
- after lock-up - 40%
- on completion - 30%.

It may not claim capital allowances in respect of the hotel until the hotel is constructed and put into use, s. 16. Once the hotel is opened, Company A may categorize the contract price to the Class 4 depreciable assets and claim capital allowances accordingly.

5.8 Capital allowance for Intangible Assets

In granting capital allowances, the Act takes a different approach to intangible assets than it does with respect to tangible assets. Each intangible asset is placed in class 5 and the depreciation period applied to an intangible asset is a function of its actual useful life.

Example 5.8.1

Mr R wishes to rent a number of offices from Company P.

The lease period is = 3 years
05.08.2018 Premium paid for entering in to lease = Rs. 300,000

The definition of "rent" in s. 195 includes the receipt of a premium. So, the whole Rs. 300,000 is treated as rent derived by Company P during Y/A 2018/2019.

The treatment of the payment of the premium by Mr R is more complex. Periodic rent paid under a lease will typically be deductible under s. 11 in the year in which it is incurred. However, this will not be the case if the rent is of a capital nature as defined in s.11(3).

The lease would be an intangible asset of Mr R and as such it falls within the definition of "asset" in s. 195. So, the premium is an expense incurred in the acquisition of an asset with a useful life exceeding 12 months, therefore, is capital in nature and not deductible, s. 11(3).

The lease will also be a depreciable asset of Mr R, s. 195. In particular, it is a Class 5 depreciable asset. So at the end of Y/A 2018/2019 Mr R will be able to claim depreciation in respect of the lease, s. 16.

In order to calculate the depreciation under the Fourth Schedule the first matter is to calculate the depreciation basis for the lease at the end of the Y/A as per Fourth Schedule paragraph 3(2), which is Rs. 300,000.
The useful life of an intangible asset is used in working out the rate of depreciation applicable to it. In this case the actual useful life of the lease is 3 years, giving depreciation for Y/A 2018/2019 of Rs. 100,000. Mr R will be entitled to a similar amount of depreciation in Years of assessments 2019/2020 and 2020/2021

Paid premium on 05.08.2018 = Rs. 300,000  
Lease period = actual useful life = 3 years  
Capital allowance for y/A 2018/2019 = \( \frac{300,000}{3} = 100,000 \)

1. Excess repair expenses which a deduction is not allowed to be added to the depreciation basis.

According to section 14(2) the deduction for repairs and improvements, for assets categorized under class 4 is limited to 5% and for all other cases 20% of the WDV of the asset at the end of previous year. Excess expense for which a deduction is not allowed shall be added to the depreciation basis of the asset year (paragraph (3) of the Fourth Schedule).

Company P runs a manufacturing business. During Y/A 2018/2019 it incurs expenditure as follows:
- 05.09.2018: Rs. 700,000 on repairs and improvements to machine A
- 08.12.2018: Rs. 1,800,000 in buying machine B
- 04.03.2019: Rs. 200,000 on repairs and improvements to machine B
- 15.07.2019: Rs. 400,000 on repairs and improvements to machine A
- 13.08.2021: Rs. 150,000 on repairs and improvements to machine A

Assume the WDV of the machine A (bought on 06.07.2017) at the end of the Y/A 2017/2018 was Rs. 2,000,000.

**Machine A**

**Repair expenses incurred on the Y/A 2018/2019**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>WDV of the machine A at the end of Y/A 2017/2018=</td>
<td>Rs. 2,000,000</td>
</tr>
<tr>
<td>Allowable deduction for repair &amp; improvements</td>
<td>2,000,000*20%</td>
</tr>
<tr>
<td>Allowable expense</td>
<td>Rs. 400,000</td>
</tr>
<tr>
<td>Expenses incurred</td>
<td>Rs. 700,000</td>
</tr>
<tr>
<td>Expenses not allowed (add to the depreciation basis)=</td>
<td>Rs. 300,000</td>
</tr>
</tbody>
</table>

In addition to the deduction for repairs and improvements, Company A will wish to claim depreciation of its machine A.

As these machines have already been classified under class 3, capital allowance for machine A is;
Machine A

2018/2019
Machine A = Rs. 2,000,000 (WDV)
Add: Repair cost = Rs. 300,000
Rs. 2,300,000
Capital allowance = 2,300,000/4
= 575,000

Or
2018/2019
Machine A = Rs. 2,000,000
Add: Repair cost = Rs. 300,000
Rs. 2,000,000
Capital allowance = 2,000,000/4
= 500,000

Repair expenses incurred on the Y/A 2019/2020

WDV of the machine A at the end of Y/A 2018/2019= Rs. 1,500,000
Allowable deduction for repair & improvements = 1,500,000*20%
Allowable expense = Rs. 300,000
Expenses incurred = Rs. 400,000
Expenses not allowed (add to the depreciation basis)= Rs. 100,000
2019/2020
Machine A = Rs. 1500,000 (2,000,000-500,000)
Add: Repair cost = Rs. 300,000
Rs. 1,800,000
Capital allowance = 1,800,000/3
= 600,000

Machine B

WDV of the machine B at the end of Y/A 2017/2018 = Nil
Allowable deduction for repair & improvements = Nil
Expenses incurred = Rs. 200,000
Expenses not allowed (add to the depreciation basis) = Rs. 200,000

New Machine
2018/2019 = Rs. 1,800,000/5
= Rs. 360,000

2019/2020 = Rs. 1,440,000
Repair cost = Rs. 200,000
= Rs. 1,240,000/4
= Rs. 310,000
2. Claiming capital allowance on repair expenses incurred by a lessee.

This has been taken from the old manual. Later the position was changed and as per section 49(2) where an asset is leased under a finance lease, the lessor shall be treated as transferring ownership of the asset to the lessee. Accordingly, capital allowances are claimable by lessee and not the lessor.

Under the terms of the lease, asset is owned by the lessor. If the lessor is engaging in a business, the asset used for the business is a depreciable asset of the lessor. Hence lessor is entitled to claim capital allowances. Sec 14 is applicable only to the depreciable assets. Since the lessee is not entitled to claim capital allowance, s. 14(2) limitation does not apply. In such a case s. 11 will apply. Hence the lessee is entitled to deduct the full costs of the repairs in the same way as the lessee would be entitled to deduct the full amount of rent paid to the lessor.

**Example 5.8.2**

Mr A leases a shop from Mr Z under a 5-year lease. Under the terms of the lease Mr A is obliged to pay Rs. 100,000 per month by way of rent. In addition, Mr A is obliged to make all necessary repairs to maintain the premises in good order and condition. During the Y/A 2018/2019 Mr A spends Rs. 150,000 on repairs, essentially some plumbing and electrical work and repainting the window front. Mr A may deduct both the cost of rent paid as well as the repair costs under s. 11. Section 14 has no application because Mr A does not own the premises.

i. Claiming capital allowance on repair expenses incurred by a lessee

The lessor will charge a certain amount of rent but be obliged to incur costs in making any necessary repairs. These repairs would be deductible to the lessor subject to the limitation in s. 14. The excess repair cost which is not allowed as a deduction due to such limitation could be added to the depreciation basis of the asset and entitled to claim capital allowance.

ii. Claiming capital allowances by lessee on improvements made by lessee.

Conceptually, repairs do not improve the value of an asset but only maintain it. By contrast, improvements enhance the value of an asset. As well improvements produce the benefit for lessee and the cost will last longer than 12 months. Accordingly, such cost will be capital nature, hence not deductible under section 11. But the expense will constitute an intangible asset of the lessee for which capital allowances may be claimed over the term of the lease.

**Example 5.8.3**

Mr P enters into a lease for 3 years with company S and under the terms of the lease, Mr P is obliged to not only make repairs but also to install a modern brick storage facility during the first year of the lease. Mr P incurs the rent and repairs. In addition, Mr P incurs Rs. 420,000 in installing the new storage facility.
iii. Claiming capital allowances by lessor on improvements made by lessee.

Improvements should be considered as a payment of rent and taxable to the lessor. In such a case, it is appropriate to treat the amount taxable in respect of the improvement as falling into the cost base of the asset in question. This would enable the lessor to claim depreciation allowances in respect of the improvement (amount included in income).

**Example 5.8.4**

According to the above example cost of improvements of Rs. 420,000 made by Mr. P (Lessee) is considered as a payment of rent to Mr. S (lessor). Hence taxable to Mr. S (the lessor.)

**5.9 The circumstances of including assessable charges or granting balancing allowances**

Where a depreciable asset of a person is realized, when calculating the person’s income;

(a) an assessable charge is included or
(b) a balancing allowance is granted

The realization of depreciable assets is dealt with in Fourth Schedule paragraph 4. Where the depreciable asset is realized, the simple rule is that the amounts derived on realization of end of the year in which the disposal takes place, to the person for the year calculated in accordance with the following formula.

**(a) Calculation of an assessable charge (profit)**

\[
\text{consideration received} - \text{written down value of the asset at the time of realization of the asset}
\]

If the amount received on realization of a depreciable asset exceeds the written down value of the asset at the time of realization, such amount will be required to include an amount in their income,

**Example 5.9.1**

Company A runs a property rental business and owns a building of apartments for rental. At the start of year 1, the balance in Company A's class 4 is Rs. 30,000,000, i.e. the balance at the end of the previous year less the depreciation allowance granted for that year. Company A is expecting to sell off a large number of the apartments in the building except for a few select apartments. As a result, during year 1 it receives Rs. 50,000,000 as proceeds from the sales.
Consideration received from the realization of apartments during the year - Rs. 50,000,000
Less: written down value at the end of the year of assessment - Rs. 30,000,000
The amount to be included in calculating its income for year 1 - Rs. 20,000,000

(b) Calculation of balancing allowance (Loss)

written down value of the asset at the time of realization of the asset - consideration received

If the written down value exceeds the amount received on realization, the excess is allowed as a deduction in calculating the person's business income.

Example 5.9.2

Company R sells office furniture at the price of Rs. 700,000 and at the time of disposal the written down value of the asset is Rs. 1,000,000.

With respect to the office furniture, Company R will be granted a deduction in the amount by which the written down value of the asset exceeds the proceeds of sale, i.e. Rs. 300,000.

Sale proceed = Rs. 700,000
WDV = Rs. 1,000,000
Balancing allowance (Loss) = Rs. 300,000

Rs. 300,000 is allowed as a deduction when calculating company R’s business income

“written down value of an asset at the time of realization of the asset” means; the expenses incurred by a person in acquiring the asset reduced by all depreciation allowances granted to the person under paragraph 2 in respect of the asset.

5.9.3 Enhanced Depreciation Allowances – Second Schedule

A person who invests in Sri Lanka (other than the expansion of an existing business) during a year of assessment shall be granted enhanced capital allowances, in addition to the capital allowances computed under the Fourth Schedule.

1. Enhanced capital allowances shall be granted to the person for the year if the total expenses incurred by that person during that year on depreciable assets (other than intangible assets) as follows;
<table>
<thead>
<tr>
<th>Criteria</th>
<th>Limitation</th>
<th>Percentage of capital allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Depreciable assets used in a part of Sri Lanka other than the Northern Province</td>
<td>exceeds USD 3 million but does not exceed USD 100 million</td>
<td>100%</td>
</tr>
<tr>
<td>2. Depreciable assets used in a part of Sri Lanka other than the Northern Province</td>
<td>exceeds USD 100 million</td>
<td>150%</td>
</tr>
<tr>
<td>3. Depreciable assets used in the Northern Province</td>
<td>exceeds USD 3 million</td>
<td>200%</td>
</tr>
<tr>
<td>4. Depreciable assets of state-owned company that are used in a part of Sri Lanka</td>
<td>exceeds USD 250 million</td>
<td>150%</td>
</tr>
</tbody>
</table>

2. Depreciation allowances arising above one paragraph of above table with respect to a particular year of assessment cannot be accumulated with another paragraph and shall be taken in that year and shall be deferred to a later year of assessment.
Chapter 6 - Investment Income

6.1. What is Investment Income?
Investment income is defined in the Act as follows; "Investment” means –

(a) The owning of one or more assets, including one or more assets of a similar nature or that are used in an integrated fashion, and
   i. Includes a past, present or prospective investment; but
   ii. Excludes a business or employment; or

(b) A game of chance, including lotteries, betting or gambling;

Accordingly, Investment involves holding assets (except for an asset being the principal place of residence of an individual, subject to conditions) passively for gain. As per the concept of dominancy over sources of income, it excludes the business or employment.

Section 7 defines the types of investment income. Accordingly, in calculating person’s gains and profit from an investment, following amounts received or derived by the person during the year of assessment shall be included.

(a) dividends, interest, discounts, charges, annuities, natural resource payments, rents, premiums and royalties;
(b) gains from the realisation of investment assets as calculated under Chapter IV;
(c) amounts derived as consideration for accepting a restriction on the capacity to conduct the investment;
(d) gifts received by the person in respect of the investment;
(e) winnings from lotteries, betting or gambling; and
(f) Other amounts required to be included under this Act.

It is noted here many of the types of the income mentioned above as investment income may also be derived in the context of business. The effective connection with the type of activity determines whether amount is from business or investment. The “effectively connected” test is a question of nexus or association. So, if an amount is derived in the context of business, it is treated as business income irrespective of whether it is mentioned in section 7. For example, interest income is definitely being a business income for a bank even if it is mentioned in section 7. Further, if an exporting company deposit its additional funds in a 5-year fixed deposit plan with a bank will amount to an investment. However, interest income earned by such company from the money kept in a bank to get export guarantees amounts to a business receipt as it is effectively connected to the business.
In this regard, IRD will continue to apply the approach of the court of Appeal in *Ceylon steel corporation limited vs Commissioner General of Inland Revenue*. Further, with amounts other than the interest (why), it is acceptable principles of generally acceptable accounting standards in classification of income items.

The Consequences attached with the decision whether an amount constitutes income from a business or income from an investment.

1. **Deduction of Expenses**

   Applicability of deduction rules on expenses depends on whether the relevant amount constitutes income from a business or income from an investment.

   Accordingly, following sections are not applicable in calculating the person’s income from investment.

   i. Section 13 - Allowance for trading stock
   ii. Section 14 - Repairs and improvements
   iii. Section 15 - Research and development expenses and Agricultural start-up expenses
   iv. Section 16 - Capital Allowance and balancing allowance
   v. Section 17 - Losses on realisation of business assets and Liabilities

2. **Deduction of unrelieved losses under section 19**

   The classification of a revenue receipt either to a business or an investment is required to apply rules of deduction unrelieved losses under section 19.

   Such applicable rules are as follows;

   i. Unrelieved losses from business may be deducted in calculating income from an investment.
   ii. Unrelieved losses from an investment shall be deducted only in calculating income from an investment.

3. **Method of Accounting**

   The requirement of the Act to keep accounts for income tax purposes under section 21 depends on whether an individual or entity conducting a business or having an investment.

   Accordingly, the section has set out following requirements;

   i. An individual shall account for income tax purposes on a cash basis in calculating the individual’s income from investment.
ii. An entity shall account for income tax purposes either on a cash basis or accrual basis whichever properly computes the entity’s income from investment.

iii. An individual or entity conducting business shall account for income tax purposes on an accrual basis.

4. Deduction of qualifying relief under section 52.

An individual who receives rental income from an investment asset, that means who receives rental income as a receipt from an investment only and not as a business receipt can claim qualifying relief referred to in section 52.

Investment and Investment Asset

As per the definitions given for “investment” and “investment asset “in section 195, owning of any kind of asset (not only investment assets) amounts to be an investment. However, to be treated as an investment asset, a capital asset, subject to the exclusion in the definition,

6.2. Investment receipts

6.2.1. Rent

“Rent” –
(a) means a payment, including a payment of a premium or like amount, for the use of or right to use property of any kind;
(b) includes a payment for the rendering of, or the undertaking to render, assistance ancillary to a use or a right referred to in paragraph (a); but
(c) excludes a natural resource payment or a royalty;

A person may lease a tangible asset in return for rent. The activity of the person in leasing the asset may or may not amount to a business, where it does not, the rent must be included in calculating the person's income from their investment,

Example 6.2.1.1

Mr. Aruna acquires an office building (and land) in 1st year for Rs. 30 million. Mr Aruna holds the building as an "investment" (defined in s. 195). Therefore, at the end of 1st year Mr. Aruna must calculate his income from the investment and (assuming that all the facts occur within Sri Lanka) this will also be Mr. Aruna 's assessable income from the investment under s. 7. Mr. Aruna 's assessable income from the investment must be included in calculating his taxable income under s. 3.

Income from an investment is calculated under s. 7(1) as the profits and gains from conducting the investment. So, in principle, any rent received from the property is included in calculating those profits and gains, s. 7(2)(a).
Withholding is required of the tenant under s. 84(1) (it is not excluded by s. 84(2)(a) unless the tenant is an individual who is not conducting a business from the rented office). Therefore, rent is subject to 10% withholding under First Schedule paragraph 8 but it is not final. Mr Aruna is able to claim this WHT as a credit from his final tax liability s.89.

Mr Aruna incurs expenditure in the form of commission for the services of the property manager. This payment of commission is deductible for Mr Aruna as it is incurred in deriving the rent.

Mr Aruna cannot deduct the expenditure on the acquisition of the building because it is of a capital nature, s. 11(2). In particular, ps. 11(3) states that expenses are of a capital nature if incurred in securing a benefit lasting longer than 12 months, which would include acquiring an asset with a useful life exceeding 12 months. The building is an asset (as per definition in s. 195) and would have a useful life exceeding 12 months. While the acquisition cost of the building is not deductible, it is a cost incurred with respect to the building under s. 37(1)(a). The land and building will be considered a single asset, and not a depreciable asset, so Mr Aruna is also not entitled to any deductions for repairs and improvements to the building (s. 14) or for depreciation of the building (s. 16). However, the benefit of repairs not lasting longer than 12 months is deductible under s.11.

If Mr Aruna does not claim above repair expenses under section 11 he will be able to claim individual relief under fifth schedule

“in the case of an individual with rental income from an investment asset, an amount equal to 25 percent of the total rental income for the year of assessment, being a relief for the repair, maintenance, and depreciation relating to the investment asset, but shall only be allowed to the extent no deduction or cost is claimed for any actual expenditures incurred by the taxpayer for the repair, maintenance, and depreciation of the investment asset;”

6.2.2. Royalties

“royalty” means a payment, including a payment of a premium or like amount, derived as consideration for –

(a) the use of or right to use a copyright of literary, artistic or scientific work, including cinematograph films, software or video or audio recordings, whether the work is in electronic format or otherwise;

(b) the use of or right to use a patent, trade mark, design or model, plan, or secret formula or process;

(c) the use of or right to use any industrial, commercial, or scientific equipment;
(d) the use of or right to use information concerning industrial, commercial, or scientific experience;

(e) the rendering of or the undertaking to render assistance ancillary to a matter referred to in paragraph (a), (b), (c) or (d); or

(f) a total or partial forbearance with respect to a matter referred to in paragraph (a), (b), (c), (d) or (e);

As discussed previously, the definition of "royalty" in s. 195 is predominately a payment for the use of intangible property. The specific inclusions in the definition are largely examples of this general approach but there are extensions, e.g. in the form of payments for the supply of know-how, ancillary payments and forbearance payments.

Example 6.2.2.1

PQR Sri Lanka Ltd manufacturer of the product A and is the patent owner for that product. During the year 2018/2019 the Company sells a temporary license to use its patent in Bangladesh to Dhaka Industries for a price of Rs. 1 million and 5% of gross profits from its use. The Company receives Rs. 500,000 from Dhaka Industries under the 5% clause. The money paid for the Bangladesh license is a payment for the use of a patent and therefore falls within the meaning of paragraph (b) of the definition of "royalty" in s. 195(2).

Though the result of Rs. 1.5 million is an amount that can be included under s. 7(3)(a), but, because the amount is effectively connected with the Company's business, Company must include the amount in calculating its income from the business - s. 6(3)(g).

The royalties received are for the use of an asset in Bangladesh and so they will have a foreign source, s. 73(1)(c) and (2). Therefore, if Bangladesh taxes the royalties, the Company may be allowed a foreign tax credit for that tax under s. 80.

6.2.3. Natural resource Payments

“Natural resource” means minerals, petroleum, water or any other non-living or living resource that may be taken from land or the sea;

“natural resource payment” means a payment, including a premium or like amount, for the right to take natural resources from land or the sea or calculated in whole or part by reference to the quantity or value of natural resources taken from land or the sea;

According to the definition natural resource payments are excluded from the definitions of "rent" and "royalty", i.e. if a payment is a natural resource payment it is neither rent nor royalty. The definition of "natural resource payment" has two branches. The first branch focuses on the "right to take" resources "from land or the sea". Such resources could be living or non-living, so the definition includes the removal of living resources such as trees, crops and fish. It also includes non-living resources such as water, minerals, soil or oil.
The resource must be taken from the land or the sea and so resources that live above the land, like most animals, are not included unless they are attached to the land, as in the case of trees and crops. Further, it is only payments for the "right to take" the resources that are covered. So, for example, a payment for the right to enter a property, cut down and take away trees is a natural resource payment, but a payment for trees that have already been cut down is not.

The second branch of the definition of "natural resource payment" in s. 195 covers indirect payments of the type covered by the first limb. It covers payments that are calculated according to the amount of natural resources to be taken from the land or the sea.

Example 6.2.3.1

Mr Kasun owns an agricultural land which believes include certain minerals. Company ABC is a mining company. In year 1 it pays Mr Kasun LKR 1 million for the right to enter his property and test for the existence of this minerals. In year 2 Company ABC discovers substantial quantities of various minerals and signs a 5-year agreement under which it agrees to pay Mr Kasun what is described as a "royalty" of 5% of the value of minerals extracted. Extraction begins in year 3 and during that year Company ABC pays Mr Kasun "royalties" of LKR 2 million under the agreement.

The payment received in year 1 is not a "natural resource payment" in s. 195 because it is not for taking resources from Mr Kasun's land but for the right to enter the land. Any right to take minerals would be merely supplementary to the main right of entry. The right of entry would be a licence and so be a "lease" as defined in s. 195. As the LKR 1 million is a payment made under this "lease", it is "rent" as defined in s. 195. It is clear that the receipt of this rent is not "effectively connected" with Mr Kasun's agricultural business for the purposes of s. 6(3)(g). Rather, the rent will be received with respect to the "investment" of Mr Kasun in holding his property. While this property will generally be considered a business asset in the context of Mr Kasun's agricultural business, it is only such an asset to the extent to which it is used in the business. The granting of the right of Company ABC to enter the land does not involve the "use" of the land in the context of Mr Kasun's agricultural business. To this extent, the holding of the land by Mr Kasun constitutes an investment. The LKR 1 million received from Company ABC constitutes rent from this investment and must be included in calculating his income from this investment, s. 7(2)(a). The "royalties" received by him in year 3 do constitute a "natural resource payment" under s. 195 and so are not a "royalty" for tax purposes. As with the payment received in year 1, the payment received in year 3 will be received in the context of Mr Kasun's investment in his property. So, he must include the LKR 2 million in calculating his income from the investment in year 3.

Company ABC required to deduct 10% WHT from 1M Rent and 14% from 2M natural resource payment and Mr Kasun is able to claim this WHT as a credit from his final tax liability s.89.
6.2.4. *Dividend*

"Dividend" is defined in s. 195(1) very broadly in terms of a payment derived by a member from a company, paragraph (a) of the definition of "dividend" in s. 195(1). The concept of "payment" imports a broad meaning as defined in s. 195(1) and so the concept of "dividend" covers all types of in-kind payments and constructive distributions. Also included in the concept of "dividend" is a capitalization of profits by a company, whether by way of a bonus share issue, increase in the amount paid-up on shares or otherwise, and regardless of whether such amount is distributed or not.

However, the amount of "dividend" is reduced by any payment made by the member to the company, debited to a capital, share premium or similar account, or otherwise constitutes a final withholding payment or is included in calculating the income of the member, paragraph (c) of definition of "dividend" in s.195(1).

**Definition of a “Dividend”**

(a) a payment derived by a member from a company, whether received as a division of profits, in the course of a liquidation or reconstruction, in a reduction of capital or share buy-back otherwise;

(b) includes a capitalization of profits –
   i. whether by way of a bonus share issue, increase in the amount paid-up on shares or otherwise; and
   ii. whether an amount is distributed or not; and

(c) excludes a payment to the extent to which it is –
   i. matched by a payment made by the member to the company;
   ii. debited to a capital, share premium or similar account; or
   iii. otherwise constitutes a final withholding payment or is included in calculating the income of the member;

**Dividend distribute by way of Bonus share:** When a company issues bonus shares the existing shareholders in the company receive extra shares. The company pays up the par or nominal value of the shares (and any premium) by transferring an amount from the company's retained profits to the company’s share capital account. But no money changes indicators when a company issues bonus shares and so an issue of bonus shares does not result in a reduction in the value of the company. Nevertheless, the issue of bonus shares as capitalization of profits is specifically treated as a dividend regardless of whether an amount is distributed or not, paragraph (b) of definition of "dividend" in s. 195(1)) and so results in a dividend equal to the paid up value of the bonus shares. When paid by a resident company, this amount may constitute a final withholding payment and subject to a 14% withholding tax, ss. 61(1)(a), 88(1)(a) and First Schedule. When paid by a non-resident company, this amount must be included in calculating the income of the shareholders, s. 61(1)(b).

However, the issue of bonus shares potentially causes a reduction in the value of the existing shares.

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In this situation, in order for the final withholding payment to qualify as a cost, then it is requiring that those costs and the costs for the existing shares are spread evenly across the bonus shares and the existing shares. If the bonus shares are of a different class to the original shares, the spreading must be proportionate to the market values of the different classes.

Example 6.2.4.1

Mr. A owns 100 shares in Company Z, a resident company. Mr. A paid Rs. 500 per share for the shares. Company Z capitalizes profits and Mr. A receives in respect of his shareholding a further 20 shares with a paid-up value of Rs. 300 per share. Company Z is treated as distributing a dividend equal to the capitalized amount of the bonus shares, i.e. Rs. 300 per share and will be liable to account for final withholding tax at the rate of 14% on this amount. Mr. A has costs with respect to his existing shareholding of Rs. 500 per share.

Mr. A has costs of a further Rs. 300 per bonus share but requires Mr. A to spread this amount and the costs of the existing shareholding evenly across the entire shareholding after the issue of the bonus shares. In order to do this, Mr. A must calculate his costs of his entire shareholding.

This amounts to Rs. 56,000 \{(100 \times 500 = Rs. 50,000) + (20 \times 300 = Rs. 6,000)\}. Mr. A must divide this amount by the number of shares he now holds, i.e. 120. This gives adjusted cost of Rs. 467 per share. Therefore, if Mr. A subsequently sells 10 shares for Rs. 5,500 he will realize a gain on disposal of Rs. 830 (Rs. 5,500 less Rs. 4,670) irrespective of whether Mr. A sells part of his original shareholding or part of his bonus shareholding.

6.2.5. Interest

“interest” includes –

(a) a payment, including of a discount or premium, made under a debt obligation that is not a return of capital;

(b) a swap or other payment functionally equivalent to interest;

- Interest to be assed is income derived from investment, loans, charges on unpaid debts, and court awards etc.

- interest income is a part of an investment income.

- The surplus received by a person for the money deposited in a bank or financial institution is interest.

- The additional amount received by a person who lends money is an interest. If any charge is not settled within specific time period, the additional amount to be charged and that is also an interest.

- Unpaid debt also increases by an additional amount and that also identified as interest.
6.2.6. Other receipts

Discount - Income from discounts means the gains derived from the casual discounting of bills of exchanges etc. Gains arising from the discounting of bills of exchange, cheques, etc. in the normal course of business considered as business income.

Charges - A charge is a sum received by a person under deed or an order of court which is secured on the income or property of payer.

Annuities - An annuity is a fixed sum receivable annually which is not a capital nature. The payment of an annuity which should be made with reference to a year may be in periodic instalment.

Example - Receipt of monthly payment after contributing of pension fund

Premiums - are payments received as a consideration for obtaining the right to use a property rather than for the actual use of the property.

Example- Receipt of key money on letting a premise

6.2.7. Gift Received on Investment

“gift” means a transfer without consideration or a transfer with consideration to the extent that the market value of the property exceeds the market value of the consideration.

6.2.8. Winnings from lotteries

Winnings from lotteries, betting or gambling are specifically deemed to be income from an investment, s. 7(3)(e). However, no deduction is allowed for amounts incurred on lotteries, betting or gambling, s. 10(a)(IX). This prohibition against deduction does not apply to amounts incurred from conducting a business of gambling.

Example 6.2.8.1

Mr A won Rs. 1 million from a lottery. He spent Rs. 100,000 on lottery tickets for that draw. Mr A must recognize all Rs. 1 million as income from an investment but may not deduct the Rs. 100,000 as expenses incurred in the production of income from the investment.

Assume Mr A runs an illegal gambling operation. The illegality of the operation does not preclude the income derived from income taxation. Mr A must recognize all income derived from the gambling operation as income from a business, and he may deduct expenses and losses incurred in conducting the business in accordance with Division IV of Chapter II.
Chapter 7 - Capital gains

For income tax purposes capital gain is treated as an investment income. The type of income is enumerated in paragraph (b) of subsection (2) of section 7 under source of investment income, as follows:

“(b) gains from realization of investment assets as calculated under Chapter IV” Accordingly, Capital gains tax (CGT) is charged on the gains arise from realization of investment assets.

The “investment asset” is defined in section 195 of the Act as follows:
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 at least two of those three years (calculated on daily
  basis)”

As defined in section 195,
capital asset –
  means each of the following assets: -
  i. land or buildings;
  ii. a membership interest in a company, partnership or trust;
  iii. a security or other financial asset;
  iv. option, right or other interest in an asset referred to in the foregoing paragraphs;
      but
  excludes trading stock or a depreciable asset”

7.1. General Rules (Sections 36-41)

Division I of Chapter IV of the Act deals with general introduction to this Chapter.. 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 realization.

In deciding the gain, the following factors need to be considered:
- Whether the asset is an investment asset as defined.
- the asset utilized prior to the realization was not in any manner connected to the business
- The gain calculated as explained below is does not exceed Rs. 50,000/- for resident individual
7.1.1. Calculation of gains and liability (Section 36)

A gain is realized when an asset is sold or exchanged at a price higher than its cost. Similarly, a loss occurs when an asset is sold for less than its cost. Gains or loss can be categorized as a business income or investment income. If it is an investment income the gain is a capital gain and if it is effectively connected to a business income, it is a trade profit and not a capital gain.

Therefore, a gain can be defined as a “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 = ********

7.1.2. Cost of the assets and liability (Section 37)

Section 37 is discussed the matter of calculating of cost of an asset. Accordingly, the cost of an asset includes expenditure that incurred in acquiring of an asset, further it can be an improvement or any incidental expenses. The term incidental expenses have been defined in the Section 37(4) itself. Example: Advertisement expenses, transfer tax, stamp duty etc.

Subsection 2 of the section 37 further elaborate a situation where income amount also considers as a cost of an asset.

Following are the examples:

- 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

Calculation Summary of Section 37

Expenditure incurred to acquire the asset = ********
(Including construction, 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 = ********
Special Note: Transitional Provisions - sec 203 (4)

According to the above provisions 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.

Example 7.1.2.1

Mr. X purchased a land for Rs 3,500,000 on 12.12.2015 and hold as his investment. The land and building value as at 30.09.2017 was Rs 4000, 000. X sold asset for Rs 6,000,000 on 1.05.2018 and incurred following expenditure before selling advertisement Rs 100,000, Brokerage fee Rs 60,000 and legal fee Rs 75000.

<table>
<thead>
<tr>
<th>Sale consideration</th>
<th>6,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Value of the asset as on 30.09.2017</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Less: Cost of an asset</td>
<td></td>
</tr>
<tr>
<td>Purchase cost</td>
<td>3,500,000</td>
</tr>
<tr>
<td>Advertisement</td>
<td>100,000</td>
</tr>
<tr>
<td>Brokerage fee</td>
<td>60,000</td>
</tr>
<tr>
<td>Legal fee</td>
<td>75,000</td>
</tr>
<tr>
<td>Cost of an asset</td>
<td>4,235,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>1,765,000</td>
</tr>
</tbody>
</table>

7.1.3. Consideration received (Section 38)

Consideration received can be cash received or receivable by the person for an asset. The concept of consideration can be form of exchange one property instead of payment is cash to another in such a situation market value of the asset consider as consideration received.

Consideration received for an asset shall be,

(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 another asset

(b) Amount received in respect of owning the asset
   Ex: Altering ,repairing

(c) Amount received or entitlement to receive in future – advance
   i. Grant of an option
   ii. Consideration received for an asset shall not include an exempt amount or final WHT.
Example 7.1.3.i

Company A is a land developer. During year 1 it gives Mr Z, one of its executives, a plot of land as a bonus. The market value of the land is Rs 2 million. This amount must be included in calculating the income of Mr Z from the employment by Company A for year 1. Mr Z sells the land in year 3 for Rs2.2 million.

<table>
<thead>
<tr>
<th>Sale consideration</th>
<th>2,200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Cost of an asset</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>200,000</td>
</tr>
</tbody>
</table>

7.1.3.1. **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.

Example 7.1.3.ii

B pays to Mr A Rs 1,000,000 for the grant of an option entitling the holder to acquire a land from A for Rs 5 M. Mr B subsequently did not exercise the option and sell the option to Mr C for Rs 2 M.

Mr A Tax Liability
Consideration = 1,000,000
Cost = 
Gain = 500,000

Mr B Tax Liability
Consideration = 2,000,000
Cost of acquisition = 1,000,000
Gain = 1,000,000

7.1.3.2. **Realization (Section 39 and 43)**

Capital gain arises when assets are sold, Section 39 (a) and (b) deal with the situation where person apart with ownership of the asset physically by way of sold, exchanged, transferred, destroyed, lost, expired etc. The death of person considers as realization of asset immediately before the death. The special provisions given in the section 44.
Deem realization

Section 39(c) to 39 (f) discussed the matter of deem realization. This means that ownership of the assets is not actually transfer to another person, deem realization take place.

7.1.3.3. Liability (Section 40)

Section 40 deals with the determination of the cost and the consideration received for liability similar to assets and subsection (1) provides for the calculation of cost of liability and consideration received, similar to the calculation of assets in section 37 and section 38 respectively.

Subsection (2) explains the special circumstances treated as realizing the liability which will arise, when person ceased to owe the liability by way of:

- Transfer, satisfy, cancel
- Death
- Change in residence

7.1.4. Reversal quantification and compensation of amount (Section 41)

7.2. Special Rule (Sec 42-51)

7.2.1. Cost of trading stock and other fungible assets (Section 42)

- This is discussed under business income. Give reference to business income - business income

7.2.2. Realization with retention of asset (Section 43)

In this section deemed realization and deemed reacquiring the assets of the person who realizes assets in the manner set out in paragraphs (c) to (f) of section 39 are dealt with.

The way of calculation of gain or loss when deemed disposal take place should be made as per section 43.

**Deemed disposal** - refers to a situation where it is considered to have been disposed even that investment asset has not actually transfer to.

**Deemed proceeds of disposal** – refers to a situation that the consideration deemed to have been received and the value is equal to the market value, even though the consideration has actually not received.

**Deemed cost** – refers to reacquire the asset and incurring expenditure of the amount equal to deemed realization.
7.2.3. **Transfer of asset to spouse or former spouse (Section 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) Individual deriving an amount equal to net cost (realisation)

\[
\text{Realisation} = \text{Net Cost of the asset}
\]

Sec 44 (b)

Person who acquire ownership of asset equal to net cost

\[
\text{Acquisition cost} = \text{Net Cost}
\]

Therefore, by applying above formula, gain will not arise.

7.2.4. **Transfer of asset on death (Section 45)**

Sections 39(b) and 40(2)(b) provide that 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. 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.

7.2.5. **Transfer of asset to an associate or for no consideration. (Section 46)**

This section provides for 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. The term associate has been defining in the sec 46(3) (a)
Example 04:

Mr. A transferred his asset to his son as follows. Land and building situated in Sri Lanka,

<table>
<thead>
<tr>
<th>Asset</th>
<th>Net Cost</th>
<th>Market value</th>
<th>Applicable Section</th>
<th>Tax liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land and building</td>
<td>5 M</td>
<td>10 M</td>
<td>46(2)</td>
<td>No gain</td>
</tr>
<tr>
<td>Family home</td>
<td>3 M</td>
<td>4 M</td>
<td>Exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td>Unlisted shares</td>
<td>2 M</td>
<td>4 M</td>
<td>46(1)</td>
<td>2 M capital gain</td>
</tr>
</tbody>
</table>

In the given scenario Mr. A and Mr. D are associates under section 46(3)(a) and also land is situated in Sri Lanka. A residential house is exempted under Third Schedule. Unlisted shares are not covered in the 46(2) then gain on realization of shares are subject to Capital gain tax and calculation as follows

Sale consideration 4,000,000
Less:
Cost of an asset 2,000,000
Capital gain 2,000,000

Section 46(4) permits the non- recognition of a gain that would otherwise require to recognized where a person transfer ownership of a business asset. Subject to fulfillment of conditions.

7.2.6. **Involuntary realization of asset with replacement (Section 47)**

This section explains the CGT obligations if the CGT asset is compulsorily acquired.

There may be a situation where a person receives money or another CGT asset (or both) as compensation when a person disposes of an asset involuntarily (or under an insurance policy against the risk of such an event happening). In this case, the person may be able to defer the liability to pay tax on any capital gain arising on the disposal subject to following conditions

- Realize an asset in manner set out in Sec 39 (a)
- 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
If above conditions are satisfied.

\[
\text{Realization} = \text{Net cost} + \text{If Compensation received exceeds cost of replacement asset}
\]

\[
\text{Cost of replacement asset} = \text{Net cost} + \text{If cost of replacement asset exceeds compensation received}
\]

Mr. A purchased building and net cost Rs 2,500,000. Asset value as at 30.09.2017 Rs 3,000,000 and the asset destroyed due to fire and asset was insured and insurance claim received Rs 3,000,000. A replace the asset for Rs 2,500,000. Assumed that all three conditions are satisfied.

\[
\text{Realization} = 2,500,000 + 500,000 (3 M - 2.5 M) = 3,000,000
\]

\[
\text{Cost of asset (Net cost)} = 2,500,000
\]

\[
\text{Gain/loss} = 500,000 (3,000,000 - 2,500,000)
\]

\[
\text{Cost of replacement asset} = \text{Net cost} + \text{(If cost of replacement asset exceeds compensation received)} = 2,500,000 + 0 (4M - 4.5M)
\]

7.2.7. **Realization by separation (Section 48)**

Section 48 is another special rule. It deals with the situation where rights or obligations are created with respect to an asset (or liability) owned by the taxpayer. The primary issue in this sort of case is whether the rights created amount to a part realization of the asset or whether the granting of the rights creates a new asset (or liability) in the hands of the owner. If the rights or obligations are "temporary or contingent" then there is the creation of a new asset. If the rights or obligations are "permanent" then there is a part realization. Under s. 48(2), rights or obligations created are permanent if they exceed 50 years. So, if a person who owns land grants a lease for more than 50 years it will be treated as a part realization of the land. If the person grants a lease for less than 50 years it will not be a part realization but, rather, the owner of the land will acquire a new asset, i.e. the lease.
Rights or obligations are contingent if they are not effective until the happening of an event or if they cease to have effect on the happening of an event.

7.2.8. **Transfer by way of security, finance lease or instalment sale (Section 49)**

How to calculate gain on realization on treasury bills.

Example 7.2.8.1

Mr X bought a treasury bill on 01.05.2018 for Rs 49,500,000. The T-bill’s term is 91 days and maturity value on 01.08.2018, is Rs 50,000,000. However, he sold it on 13.06.2018 for Rs 49,750,000. The effective yield rate was 4.05.

1. Calculation of interest = Purchase price * Effective Yield * Number of days T–bill held/365
   
   \[
   = 49,500,000 \times 4.05\% \times \frac{44}{365}
   \]
   
   = 241,668

2. **Calculating capital gain**
   
   Sale consideration = Rs 49,750,000
   
   Less: Interest = 241,668
   
   Net Consideration
   
   Less: Cost = Rs 49,500,000
   
   Capital Gain = Rs 8,332

7.2.9. **Apportionment of cost and consideration received. (Section 50)**

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 apportionment between assets.
Administration Provisions

7.2.10. Filling of CGT

A person disposing of a capital asset should be required to file a CGT return within one month after the realization of the capital asset. The CGT tax is imposed on a transactional rather than periodic basis. Consequently, a separate return must be file in respect of each transaction. A person who fails to file tax return on or before the due date shall be liable to pay a penalty as per Section 178.

Ex: Mr X realized his land on 01.05.2018 and Mr X need to submit return on or before 01.06.2018.

7.2.11. Payment of CGT

The CGT payable by a person on the disposal of a capital asset should be due on the date for filling the tax payer’s CGT return in respect of realization. Where the Commissioner General is satisfied that an investment asset has been realised in two or more parts then instalment payment can be paid and tax credit will be available.

Ex: Mr X realized his land on 01.05.2018 and Mr X need to submit return on or before 01.06.2018

7.2.12. Exemption

Capital gain exemptions are limited and mentioned in the Third Schedule.

- A capital gain that does not exceed an Rs 50,000 is exempt from capital gain tax and where the total gains made by the resident individual from the realization of investment assets in the year of assessment do not exceed Rs. 600,000,

- This exemption is applying for the joint–owned property so that the exemption applies only if the total capital gain made by all the joint owners of the property does not exceed the Rs 50,000.

Example 7.2.12.1:
The capital Gain arise from realization of land amount to Rs 1500,000/=, Land is owned by three individual equally, then each individual share equal to 331/3%. but Rs 50,000 allowance is apply for the total gain not for the individual portion. Then calculation as follows.
Capital gain = 150,000
Joint ownership share = 331/3%
Taxable Capital gain for each individual = 50,000
Tax on Capital gain = 5,000

- A capital gain arises by a resident individual on disposal of individual’s principle place of residence is exempted provided it has been owned by the individual continuously for the three years before being realized and lived in by the individual for at least two of those three years (calculated on a daily basis)

- Gain made on realization of an asset consisting of shares quoted in any official list published by any stock exchange licensed by the Securities and Exchange Commission of Sri Lanka.

### 7.2.13. Capital Loss

As per Section 19(5) Capital loss cannot be set-off against any capital gain (nor deductible against other forms of taxable income)