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Disclaimer

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A Note from the Faculty of Taxation Chairman

Chinese Philosopher Lao Tzu once said, "***The people are hungry: It is because those in authority eat up too much in taxes***," and I find this quote very relevant as our country continues to be crippled by an ongoing economic crisis of unimaginable magnitude, which has also resulted in a humanitarian emergency which has affected millions.

Therefore, in our continuing efforts to enhance the knowledge and understanding of our members, this second issue features some important contributions on tax as well as the economy, which I am certain will be immensely insightful to our members, especially as Chartered Accountants are known to play a critical role in helping develop an effective tax system.

Hence, this issue has been dedicated to our members, to help them enhance their knowledge on this critical subject. I am certain this issue will be beneficial to our members locally, and also overseas, and the knowledge they gain from this will be immensely valuable for their career progression.

I also invite our members to contribute to this journal by penning their thoughts on current affairs ranging from not just tax but also on the economy and other pertinent subjects, which are relevant at a local and global context.

TISHAN SUBASINGHE
Chairman of the Faculty of Taxation

Editor's Note

The second issue of the CA tax journal is published at a critical juncture of our country's history. We are plagued by an economic crisis that has crippled the lives of people. The current inflationary pressures are making it difficult for people to afford even their basic necessities. At a time like this, our authors have looked at pertinent issues that are of importance to both Chartered Accountants and other professionals.

Given the current inflation rates, Sri Lanka is heading towards a hyper-inflationary situation if not arrested quickly. Zimbabwe has faced hyper inflationary economic circumstances and we have an economist in Zimbabwe, explaining what it is like to live in such an economic ethos. This provides an insight into what we should anticipate if the current trend continues unabated. It also lists certain mistakes we should avoid if we are to avoid a similar economic rut.

We saw the exchange rates in Sri Lanka fluctuating significantly in March 2022. The fixed exchange rate of LKR 203 for a dollar was allowed to trade at market rates without any control in March 2022. This change in policy saw certain companies, especially in the export sector reporting significant profits due to exchange gains and certain companies reporting significant exchange losses. As tax practitioners the treatment for tax of these exchange gains and losses is a question of timely importance. One writer delves into the tax treatment of exchange gains and losses.

We also have a CA member of an overseas chapter contributing to this issue with an update on the implementation of Value Added Tax (VAT) in the UAE. With the Gulf countries introducing sales taxes, this will be useful for those doing business activities in these countries.

In implementing tax policies, it is important to understand the psyche of the taxpayers. One author has researched on the behavior of SME taxpayers in order to understand the compliance habits of such taxpayers. This will be an eyeopener for the policymakers in devising tax policies. This issue also includes a write up on how the National Budget can be used as an economic tool in the present economic context. Aligning the tax policies of the Government in line with the aspirations of the people is a sublime art of balance.

DINUSHA RAJAPAKSE
Editor

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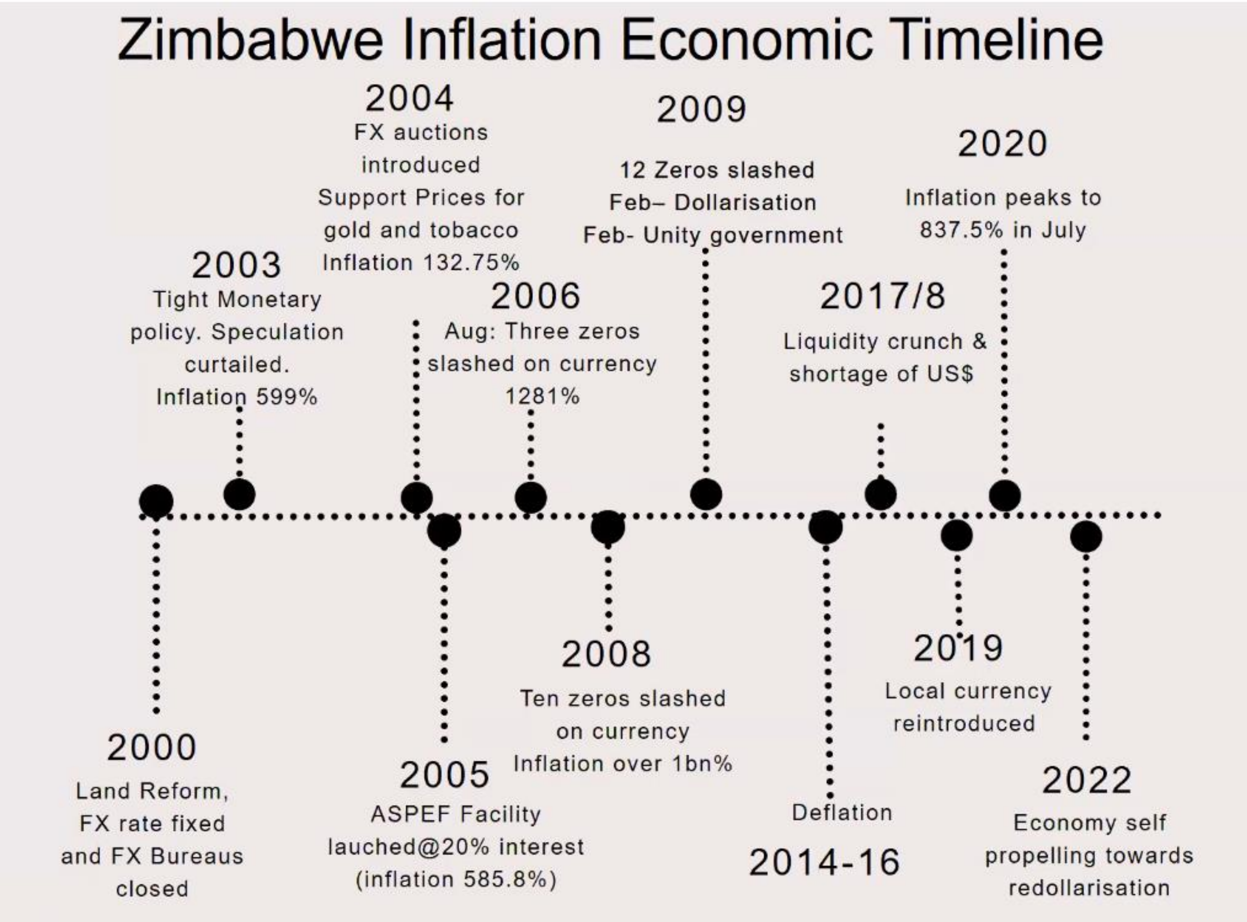
CHALLENGES IN HYPER-INFLATIONARY SITUATION

REAL LIFE EXPERIENCE IN ZIMBABWE

This article provides a summary of the presentation made by Mr. Emmanuel Dhenhere,Managing Partner of KRES Chartered Accountants, Zimbabwe and Brains Muchemwa, Economist in Zimbabwe at a webinar organized by CA Sri Lanka Business school on 11th April 2022.

What causes hyper-inflation?

Hyperinflation is caused by people. Where there is hyper-inflation there is a series of carefully coordinated and well correlated bad decisions being consistently implemented with amazing resolve by a handful of policy makers. These decisions generally result in disastrous consequences because this thinking process then leads to certain actions being taken. For example, (1) fiscal imprudence like high budget deficits (2) foreign debt which are imprudently contracted and (3) populist policies like subsidies and manipulation of the exchange rate.



2000	The Government of Zimbabwe introduced the Land Reform laws to re-possess lands which were largely in the hands of the white community in line with national aspirations. This resulted in capital flight and exchange rates started losing ground. The Government started printing money to support the Land Reforms.
2003	Many policy interventions to curtail high inflation.
2004	Low inflation is reported due to the measures that had been taken in 2003. Based on the success of achieving low inflation rates the policy makers started relaxing the monetary policies. The Central Bank started introducing new instruments/schemes. Since it is an agro based economy the Government provided subsidies to tobacco farmers which was supported by money printing.
2006	Slashed three zeros from the currency. Central bank started engaging in quasi fiscal activities. The Government continued printing more money. Huge money supply in the domestic market.
2008	It was difficult to transact using the local currency since the price needed to change on an hourly basis. Ten zeros slashed from the currency.
2009	The local currency was not accepted by anyone. It was better to close businesses and hold onto real assets since there was no time to invest money in business and generate any output since money will have lost value by that time. Twelve zeros had to be slashed from the currency. The Government was forced to dollarize the economy unofficially. There was no formal arrangement with the United States of America. The Government was prevented from printing money. This helped stabilize the economy.
2014-2016	Economy was improving. There was improved competition. The Government did not have USD and had to collect money through taxes to settle dues. All banks in Zimbabwe had to clear payments through the Central Bank. The Government misappropriated the USD that was channeled through its systems.
2017-2018	Severe liquidity crunch and USD shortage. The policy makers never went out of their desire to spend what they did not have.
2019	Local currency was re-introduced. People had lost confidence in the banking system and refused to deposit USD in banks since they were not able to get their money back.
2020	Inflation peaks again since the Government was pumping in more local currency to the system.

The sectors that are severely affected due to high inflation are entities which have cash as their working capital. This is because money is losing value and it is very difficult to retain value in cash. Therefore, sectors like banks and retirement funds are sectors which are mostly affected in an inflationary environment.

Lessons for Sri Lanka from Zimbabwe's experience

The debt levels in Sri Lanka are very high and there is a debt crisis. The country does not have the capacity to meet its debt obligations in USD when due. The reserves are stretched to the limit. The import cover is for about one month. Significant debt maturing during 2022 to 2026. The tourism sector may not recover at the pace required to keep up with these payments. Significant tax cuts mean the revenue to the Government is reduced. A combination of all this will lead to a severe debt crisis in the future.

The market generally creates expectations. Even though the policymakers indicate that they have a plan to arrest the situation, the people will tend to disbelieve the policymakers. Therefore, they will start acting in ways that are not anticipated and this will drive exchange rates higher. This creates a temptation for the policymakers to fix the exchange rate. The consequences of this will be curtailing the inflow of foreign currency. However, the import bill will still remain high since essentials like fuel and food need to be imported. The country also needs foreign currency to service its debts. This will create a shortage of dollars in the market. When the exchange rate is fixed, someone ends up paying the real cost of the goods. The Government when it cannot afford to make these payments are tempted to print more money to buy dollars. This will drive up inflation.

In Zimbabwe, fixing the exchange rate did not bring the desired outcome. Zimbabwe tried to arrest transactions happening through parallel markets as well. But that did not work either. The Government ended up having to subsidize the economy. In Zimbabwe, fuel, bread, cooking oil were all subsidized. It is not prudent to subsidise any items since this means that the people are paying less than the cost of these items. This leaves the Central Bank to foot the bill. However, with budget deficits the Government is not in a position to meet these expenses. Therefore, subsidizing is not a viable in these circumstances.

In Sri Lanka, the Central Bank net debt to the Government rose from Rs. 400 Bn in 2019 to about Rs.2,000 Bn in 2021. This is a significant increase which shows that the Central bank to a certain extent is engaging in quasi fiscal activities. As this is an injection of funds into the system, it will eventually result in the Central Bank having to mop up the excess money supply at a cost. Commercial banks have increased their holding in Government assets crowding out the private sector.

In Zimbabwe, there were serious challenges with State owned enterprises (SOE). They were reporting significant losses and these losses had to be monetized by the Government. They did this through printing money. This is an issue that Sri Lanka too will have to address. With institutions like the Ceylon Petroleum Corporation (CPC) and other SOEs reporting significant losses, the Government needs to avoid the trap of subsidizing items like fuel to appease the people and start pricing these items at cost.

Snapshot of key lessons for Sri Lanka

- Fiscal Consolidation is key in averting high inflation
- An independent Central bank which can successfully implement credible reforms
- Fixing the exchange rate, capital controls, price controls and other administrative controls to reduce inflation only exacerbate the situation
- Populist policies, in particular subsidies hurt the very people they will be attempting to protect
- It’s possible to lose everything, from pensions accumulated over year, assets and dignity

NAVIGATING TAX WITH TURBULENT CURRENCY

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From an Economist to a layman, it's accepted that Foreign Currency is the cause and also the solution to the Sri Lankan Economic Crisis. In such a context where foreign exchange transactions are being highly regulated, the businesses are required to play a transformative role in the economic revival of the country while facing difficult and uncertain economic circumstances. Hence, it is important to understand how foreign currency transactions are recorded in the books of a business and the imposition of tax on the same.

Recording Foreign Currency Transactions

In relation to accounting treatment of foreign currency transactions, Sri Lanka Accounting Standard – LKAS 21 *"Effects of Changes in Foreign Exchange Rates"* requires an entity to determine the 'functional currency' or the currency of the primary economic environment in which such entity operates as per the guidance provided therein. The functional currency of an entity corresponds with the underlying transactions of such entity, and it cannot be changed unless there is a change to the underlying transactions, events and conditions upon which it is based.

Further, as per LKAS 21, an entity is entitled to present its financial statements in any currency and where such presentational currency is different from the functional currency, the entity may translate its results to the presentation currency. In respect of the initial recognition of foreign currency transactions, the said accounting standard provides that such transactions should be recognized in the functional currency as per the spot exchange rate (the exchange rate for immediate delivery) between the foreign currency and functional currency as at the date of the transaction, i.e. the date on which the transaction first qualifies for recognition in accordance with SLFRSs. However, due to practical reasons, approximate rates such as average rate of the week or month may be used but where there is a volatile exchange rate in the market such as in the recent past, the use of an average rate may not be appropriate.

Additionally, as per LKAS 21, at the end of each reporting period, foreign currency monetary items such as provisions to be settled in cash, lease liabilities or any receivable for a fixed or determinable number of units of currency should be translated using the closing rate, i.e. the spot exchange rate at the end of the reporting period.

Taxing Foreign Currency Transactions

In an instance where an entity purchases or sells goods or services priced in a foreign currency, the initial recognition in the books of accounts will be based on the spot exchange rate as at the date of the transaction. However, if such payables are settled or receivables are received during the reporting period, these transactions are recorded at the exchange rate on the date of settlement and if not settled, the closing rate will be applied to record the same at the end of the reporting period. Any resultant exchange difference will be recognized in the income statement for the period in which they arise.

In respect of tax implications on recording such purchase or sale of goods and services denominated in foreign currency which are settled in the same reporting period, the exchange difference will form part of the cost or income for tax purposes. As such, any additional cost resulting from unfavorable exchange fluctuations will be deductible in the Corporate Income Tax calculation of the entity to the extent the underlying transaction qualifies for a deduction, subject to the provisions of the tax law. Similarly, any additional income will form part of the original income and will be taxed on the same basis at the same rate of tax applicable. Again, subject to the provisions of the tax law as mentioned, any payable or a receivable not settled at the end of the reporting period will be translated at the closing rate and recorded in the income statement as an unrealized exchange gain or loss and will be either liable or deductible for tax only in the period in which such transactions are settled.

Another common transaction involving any monetary items is where an entity borrows or lends funds with the amount payable or receivable denominated in foreign currency. Similar to the above, if such payables or receivables are settled in full or part in the reporting period, there will be a realisation of a liability or an asset for tax purposes and the exchange rate difference between the date of realisation and the initial recognition will result in either an exchange gain or loss. Income Tax liability on any resultant gain from the realization of the asset or liability primarily depends on the fact whether the asset or the liability amounts to a business or investment. If it is considered a business, income tax rate applicable to the particular business would be applied. Whereas, in the case of a gain arising from the realization of an investment asset, the applicable tax rate is 10%. If the realization of an asset or liability results in a loss, the deductibility is primarily determined based on whether it is a business or investment. If the loss is considered as a business, it is duly deductible in computing the business income, however subject to the other provisions of the tax law. Whereas, if such asset or the liability is considered as an investment, the loss could be deducted only in calculating the investment income, however subject to the other provisions of the Inland Revenue Act in use. Any amounts not settled within the reporting period will be recorded as an unrealized gain or loss in the income statement at the end of the reporting period as per the closing rate.

In the event an entity acquires or disposes an asset or incurs or settles a liability, denominated in foreign currency, there will be a realisation of such asset attracting tax on any gains from such realisation. The cost and consideration of the realisation will be determined as per the provisions of the tax law but in the case of an investment asset held by a person as at September 30, 2017, the market value of such investment asset as at such date will be deemed to be the cost. The consideration received on realisation in excess of the cost will be the gain from realisation and such gain will be liable for Corporate Income Tax at the income tax rate applicable to the business, if such income amounts to a business income. If such Income amounts to an investment income, the gain will be liable at the standard rate of 24%. However, a concessionary rate of 10% is applicable on the gains arising from the realization of investment assets.

Complexities Moving Forward

There are many complexities in terms of recording and the taxation of transactions in foreign currency particularly in relation to fair value adjustments and determining if there is a realisation for tax purposes or not. Any non-monetary items such as amounts prepaid for goods and services, provisions that are to be settled in delivery of a non-monetary assets and property, plant and equipment that are measured in terms of cost in a foreign currency should be translated using the exchange rate at the date of the transaction while non-monetary items that are measured at fair value in foreign currency shall be translated using the exchange rate at the date of measuring the fair value for the purpose of accounting.

Further, a business may have foreign operations, i.e. it may be a foreign entity operating in Sri Lanka through a branch or a subsidiary or it can be a local entity, which is a parent or a head office with foreign operations. In such cases too, identifying and managing the tax costs involved with foreign operations will be crucial especially if the functional currency of the entity is different from the currency in which the foreign operations are carried out.

Finally, in the prevailing context with volatile exchange rates in the country, if the functional currency is a currency of a hyper-inflationary economy, the entity's financial statements may have to be restated in accordance with LKAS 29 on '*Financial Reporting in Hyperinflationary Economies*' and that such restatement may impact the taxation of the business, the significance unknown.

Reference

Sri Lanka Accounting Standard – LKAS 21 *The Effects of Changes in Foreign Exchange Rates*
Inland Revenue Act, No. 24 of 2017 (as amended)

VALUE ADDED TAX (VAT) IN THE UNITED ARAB EMIRATES

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The objective of this article is to provide an overall understanding of the Value Added Tax (VAT) framework in the United Arab Emirates (UAE) and the application of VAT laws in certain industries.

VAT provides a new source of income, contributing to the continued provision of high-quality public services in the UAE. It also helps the government to move towards its vision of reducing dependence on the income derived from oil and other hydrocarbons. VAT was introduced across the UAE since 1st January 2018 at a standard rate of 5%.

The UAE is part of a group of countries closely connected through "The Economic Agreement between the GCC States" and "The GCC Customs Union". The GCC group of nations have been historically working together in the design and implementation of new public policies. Accordingly, VAT has been implemented in collaboration with GCC states.

The Federal Tax Authority (FTA), the government entity responsible for the administration, collection and enforcement of federal taxes, was established in 2016 by the President of the UAE. Thus, the UAE – VAT is administered by the FTA. The followings are the main pillars on which VAT was implemented and are administered. There have been subsequent amendments and issuance of cabinet decision, guidelines, and public clarifications with respect to the application of VAT on different industries.

- Federal Decree-Law No. 13 of 2016 on the Establishment of the Federal Tax Authority, and its subsequent amendments,
- Executive Regulation of Federal Law No. 07 of 2017 on Tax Procedures (Cabinet Decision No. 36 of 2017 and its amendments),
- Common VAT Agreement of the States of the Gulf Cooperation Council (GCC),
- Federal Decree-Law No. 8 of 2017 on Value Added Tax,
- Executive Regulation of the Federal Decree-Law No. 8 of 2017 on Value Added Tax (Cabinet Decision No. 52 of 2017 and its amendments) and
- Cabinet Resolution No. 40 of 2017 on Administrative Penalties for Violations of Tax Laws in the UAE, and its amendments

Registration for VAT & the Submission of VAT Returns

A business shall register for VAT when their taxable supplies and imports exceed the mandatory registration threshold of AED 375,000 (USD 100,000). A business may elect to register for VAT voluntarily even if their supplies and imports are less than the mandatory registration threshold but exceed the voluntary registration threshold of AED 187,500.

However, when a foreign entity provides service to customers in the UAE where the customers are the end-users and the entity is unable to report FTA on the imported services in the UAE, such entity is required to register with FTA for VAT immediately.

Individual or group tax registration is possible if certain conditions are met by the businesses.

Generally, the submission of VAT returns shall be on a monthly or a quarterly basis as determined by the FTA. The VAT returns are submitted electronically where no detailed invoices or schedules are required on the electronic submission unless it is requested by FTA during a tax audit. Thus, the summarized numbers are submitted electronically by saving costs and time for businesses.

Tax Rates

Currently, the supplies are subject to zero-rated and 5 percent. Unless the supplies are not taxed at 0% or exempted, they are subject to 5% VAT. Where supplies are exempted, input VAT incurred on such supplies are non-recoverable and hence result in an expenditure to the business.

The following are the VAT exempted supplies:

- Certain financial services,
- Supply of residential buildings through the sale of lease other than the residential properties subject to zero rated,
- Supply of bare lands and
- Supply of local passenger transport.

The UAE government ensures to reduce the VAT impact on certain industries by taxing them at zero-rate where businesses are entitled to claim their input VAT on expenses unless they are non-recoverable as per the VAT laws and regulations. It's noteworthy that the approved schools and universities, basic health-care facilities, supply of international transportation of goods and related services, supply of crude oils and natural gas, supply of precious metals, export of goods or services and first supply of residential building by sale or lease within 3 years of its completion are taxed at zero-rate among others.

The UAE is a hub for international and local real estate investors where businesses are entitled to claim the input VAT in full on the development cost of residential buildings. However, the completed building falls under the exempted category after its first supply. Generally, input VAT on the maintenance cost or any other costs related to residential building is non-recoverable after its first supply. The claim of VAT refund is not limited to a specific period.

As far as supply of non-residential properties by sale or lease, whether the first supply or the subsequent supplies, the sale or lease of commercial or retail or hotel or serviced – apartments are subject to 5% VAT unless such commercial units are sold as part of a transfer of a going-concern, which is outside the scope of VAT.

The UAE being one of the low-income tax or tax-free countries, head offices or branches in the UAE enjoy a low-income tax- or tax-free business profits where the supply of goods or services are carried out outside the UAE territory while transactions are reported by the UAE entity. Generally, such transactions are outside the scope of VAT.

Reverse Charge Mechanism

Where a tax liable person imports concerned goods or concerned services for the purposes of business, the registrant shall be treated as making a taxable supply to himself and shall be responsible for all applicable tax obligations and accounting for due tax in respect of these supplies. There are certain provisions made in the VAT returns for registrant to report such transactions subject to reverse charge mechanism.

Tax registrant is required to link the business's Tax Registration Number (TRN) with the relevant Customs Authorities in the UAE for the purpose of importing goods into the UAE. The Customs Authorities report VAT on concerned imported goods in the registrant's VAT return. Hence, VAT on import is due on the due date of the VAT returns whereby helping business to manage its cash flows.

Similarly, the tax registrant is required to report VAT on imported services in the relevant VAT returns. VAT on import of goods and services are claimable if the provisions laid down in the VAT laws and regulations are satisfied.

Tax Free Shopping

The UAE is one of the most popular destinations in the world for millions of international visitors for the purpose of shopping and leisure. The UAE has implemented VAT refund scheme for tourists effective from 18th November 2018. The VAT refund scheme for tourists includes a fully integrated electronic system that creates a direct link between 13 air, land, and maritime entry and exit ports across the UAE, with more than 13,800 stores registered with the Authority, allowing the tourists to submit tax refund requests on their purchases. The system relies on advanced technologies allowing the tourists eligible for tax refunds to reclaim the VAT they have incurred, provided that they meet the conditions and criteria specified in the government decisions issued in this regard.

Business Visitors

Only foreign businesses are eligible to apply for a refund, if they have no place of establishment or fixed establishment in the UAE or an Implementing State (the GCC States that are implementing a Tax law pursuant to an issued legislation), they are not a taxable person in the UAE, they are not carrying on business in the UAE and they are carrying on a business and are registered as an establishment with a competent authority in the jurisdiction in which they are established. The approved list of countries with reciprocal arrangements has been provided by the UAE Ministry of Finance (MoF) and can be found in the List of Countries with Reciprocal Agreements for the Business Visitors VAT Refunds ("Approved List").

Non-compliance with VAT Laws and Regulations

Cabinet Resolution No. 40 of 2017 on the Administrative Penalties for Violations of Tax Laws in the UAE, and its subsequent amendments state the penalties for non-compliance with the tax laws and regulations.

Conclusion

The UAE has imposed a very competitive VAT rate for supply of goods and services. The 5% rate is a lower rate compared to other countries in the region and outside. The implementation of VAT laws and regulations has supported businesses in a way to manage their cash flows or to claim their input VAT without a time constraint. Recently, the FTA has implemented certain administrative penalties, waivers and administrative penalties instalments, which could have a positive impact on the businesses' cash flows. The tax administration system is simplified, and the service is available electronically. The 5% VAT is a burden to the end-users while UAE government expects to utilize the tax revenue to serve its citizens and residents with better public

CORPORATE TAXPAYERS AND TAX COMPLIANCE BEHAVIOURS IN SRI LANKA

Sehan Dilshan Samararathna B.B.A (Acc) Special

Introduction

Tax is a significant funding source for government expenditure in both developing and developed countries. Taxation has acted as a platform for wealth redistribution and poverty alleviation, among other economic and social issues. One of the early forms of taxation was the Roman customs and excise duties, followed by property and income taxes levied in Britain after the Norman Conquest. During the past, the principal purpose of raising taxes was to fund wars. The concept of taxation began in Great Britain in 1799 to collect revenue for the government to manage the war against France. However, taxes were levied from ancient times by the revenue authorities. From 1840 onwards, income tax regimes were installed periodically in various countries around the world. According to various sources, income tax was initiated as a regular source of government revenue from 1840 in Switzerland, 1849 in Austria, 1860 in England and India, 1862 in United States and 1864 in Italy. Today, taxes imposed by the world's international tax structures are commonly used to meet the public needs of society, including the delivery of goods and services to its people.

Sri Lanka is an island country near the south-east of India in the South Asian region, with a land area of just over 65,610 square kilometers and a population of 22 million. Sri Lanka also has an extensive history in terms of charging income tax. Income tax was first introduced to Sri Lanka in 1932 and the first year of assessment was 1931/1932. In the same year, the Department of Income Tax was established to administer taxes in Sri Lanka and Mr. N. J. Huxham was the first Commissioner of General. In 1993, the Estate Duty and Stamps Offices were combined with the Income Tax Department and called as "Department of Income Tax, Estate Duty and Stamps".

One important reason for imposing taxes by the government is to raise revenue to run the economy and redistribute wealth. In 2020, tax collection as a percentage of Gross Domestics Products (GDP) in developed countries like the United States of America (USA) and the United Kingdom (UK) were 25.5% and 32.8% respectively. For developing countries, such as Malaysia and Singapore in 2019, the tax collection as a percentage of GDP was 12.4% and 13.3% respectively. When it comes to Sri Lanka, as per the Central Bank Report the total tax revenue as a percentage of GDP was recorded at 8.1% in 2020 compared to 11.6% in 2019. Due to the inherent weaknesses in the tax system in Sri Lanka, it has failed to generate sufficient government revenue. To ensure revenue maximization, an effective and efficient tax collection process is essential.

Many countries have taken a range of steps to improve income collection. These include changing the assessment framework for direct taxes from direct assessment to self-assessment systems (SAS). Many countries have shifted to SAS, for example, Sri Lanka (1972), Pakistan (1979), Indonesia (1984), Australia (1986-87), Ireland (1988), New Zealand (1988) and the

United Kingdom (1996-97). SAS's effectiveness depends on some requirements, including tax knowledge of the taxpayers, simplicity of the tax system, effective implementation of the tax laws and penalties, excellent service to taxpayers, simple filing procedures and risk-based tax audits. These requirements encourage taxpayers' voluntary tax compliance effectively.

This article focuses on corporate income tax, which is the main type of direct taxation in Sri Lanka under SAS. Corporate taxpayers play a significant role in the economic growth of the country and it contributes a significant percentage of revenue to the government's income. Inland Revenue Department (IRD) states that Corporate Income Tax (CIT) is an essential revenue source for Sri Lanka's government, accounting for about 62% in 2018 compared to 58% in 2017. In summary, the percentage of IRD's collection to GDP from corporate income tax is about 3.5% in 2020 and 6.83% in 2019.

A decrease in the tax revenue as a result of non-compliance with tax laws is a stumbling block in achieving the fiscal objectives of the Government. This article provides insight into the explanations for non-compliance among corporate taxpayers and it examines the relationship between tax compliance costs, attitudinal aspects and compliance behaviour of Sri Lankan Small and Medium Enterprises (SMEs).

Key Definitions

Taxation

According to section 195 of the Inland Revenue Act, No. 24 of 2017, tax means a compulsory payment to the government imposed under the act regardless of whether that payment is selected as a tax, fee, duty, levy, or else and unless the context otherwise requires, includes withholding tax, instalments, interest, late fee or penalty relative to tax.

Tax Compliance

Tax compliance is filing all required tax returns at the proper time and that the returns precisely report tax liability under the tax code, guidelines and court decisions related at the time the return is filed.

Tax Non-Compliance

Tax non-compliance is perceived as the failure of a taxpayer to report the actual income, claim deductions, rebates, and remit the actual amount of tax payable to the tax authority on time.

Small and Medium Enterprises (SME)

Section 195 of the Inland Revenue Act No. 24 of 2017 defines SME as a person who conducts business solely in Sri Lanka other than an individual who is engaged in providing professional services individually or in partnership being an individual who is professionally qualified, and the person does not have an associate that is an entity, the person's annual gross turnover is less than Rs. 500,000,000 and the person's or his associate's aggregate annual gross turnover is less than Rs.500,000,000, if such associate is an entity or entities. The tax rate is 14% for year of assessment (Y/A) 2020/2021.

Relationship between tax compliance costs, attitudinal aspects and compliance behavior of Sri Lankan SMEs.

Tax compliance costs and tax attitudinal aspects are considered as independent variables, whereas tax non-compliance behaviour is considered as the dependent variable.

Figure 1 shows the relationship between tax compliance costs, attitudinal aspects and compliance behaviour.

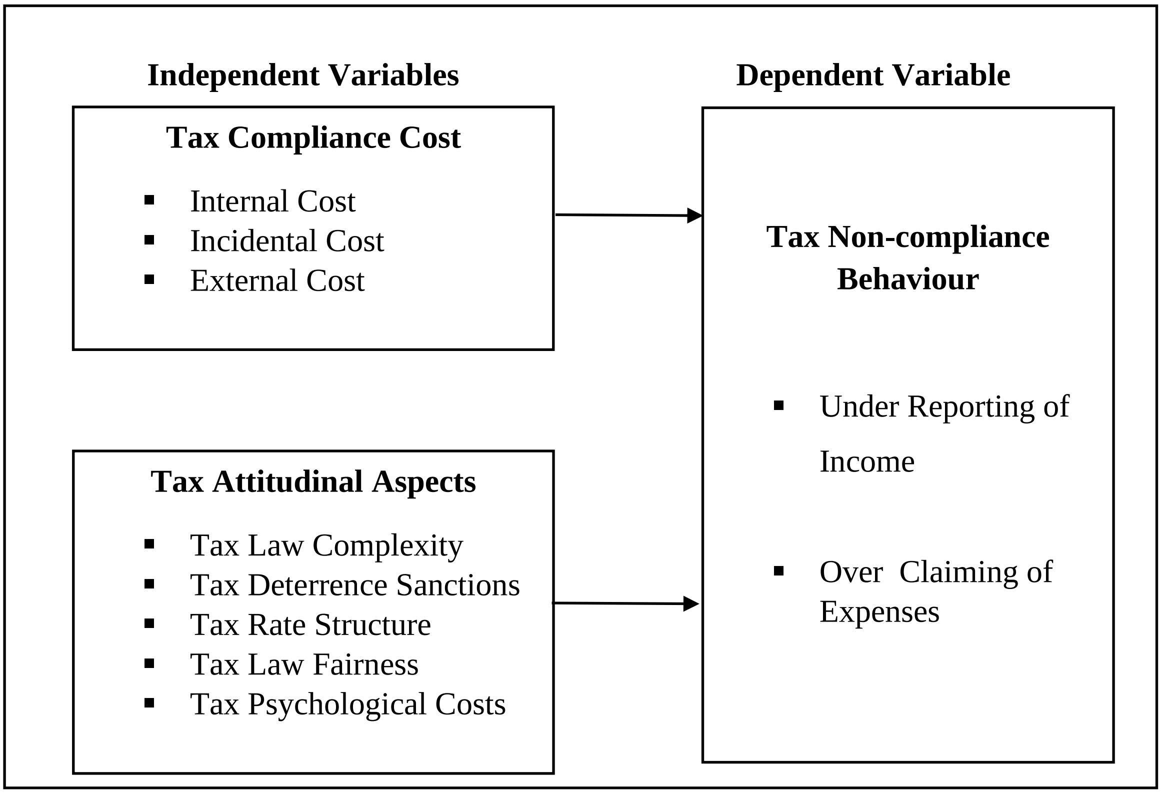

Figure 1. Conceptual Framework

Tax Compliance Costs

Tax compliance costs are the costs that taxpayers incur when dealing with the tax authority to comply with its requirements.

Internal Cost

Internal costs are the costs that are incurred within the business, comprising mainly staff time cost that is incurred within the business.

Incidental Cost

Incidental costs are the costs other than staff time costs, typically incurred by the business, such as costs of printing, stationery and communication expenditure known as miscellaneous, other and non-personnel costs.

External Cost

External costs are the costs that are incurred externally by the business, comprising fees paid to external tax professionals such as accountants and attorneys.

Tax Attitudinal Aspects

Taxpayer's attitudes may be influenced by many factors which eventually influence taxpayer's behaviour. It can be divided into five aspects namely, tax complexity, tax rate structure, tax deterrence sanctions, tax law fairness and tax psychological costs.

Tax Complexity

Complexity is clearly a major determinant of tax compliance. Corporate taxpayers prefer simple tax law to gain an easier understanding of taxation and easy preparation of income tax returns.

Tax Rate Structure

The tax rate is imposed by the government based on an individual's taxable income or a corporation's earnings. It is still unclear how this variable impact taxpayer compliance.

Tax Deterrence Sanctions

Deterrence by punishment has been defined as a method of retrospective interference, by holding out threats that whenever a wrong has been actually dedicated, the wrongdoer shall incur punishment.

Tax Law Fairness/ Equity

This refers to the taxpayer's view on the overall fairness of the tax system. The concept of tax fairness is not a simple one.

Tax Psychological Cost

Tax psychological cost are the costs imposed on taxpayers having to deal with tax activities, such as stress and anxiety.

Conclusion

In a country like Sri Lanka, tax compliance behaviour is significantly important because the primary source of government revenue is through taxes. This article primarily focuses on Sri Lankan tax compliance behaviour of SMEs through tax compliance cost and tax attitudinal aspects.

The majority of the SMEs in Sri Lanka are in the service sector. There are a significant number of SMEs operating in the manufacturing, plantation, agriculture and construction sectors as well.

All the independent variables namely incidental costs, external costs, tax complexity, tax rate, tax deterrence sanctions, tax law fairness and psychological cost except for one variable are significantly affected by tax non-compliance behaviour. In contrast, the variable namely internal cost is not affected by the tax non-compliance behaviour.

Corruption has a significant influence on tax compliance by businesses. Where Governments impose high tax rates, there is a greater likelihood of taxpayers paying off tax officers.

Tax complexity and tax audits are also related to non-compliance behaviour, where the impact of complexity is very high and the effect of the audit is fair. Reducing tax complexity and rising audit rates would help taxpayers to be compliant while tax compliance costs are not strongly related to non-compliance as a significant factor. Tax audit and tax penalties are necessary to make tax collection more effective. Corporate taxpayers have a greater tendency to adopt aggressive tax positions/interpretations where the perceived economic benefits outweigh the penalties and punitive measures provided in the tax law. Therefore, tax audits and penalties and the administration of these by the Inland Revenue officers if key to ensure proper collection of taxes. In certain instances, however, corporate decision-makers may not support aggressive tax treatments with material positive expected values due to moral/social factors.

Based on the findings, incidental costs, external costs, tax complexity, tax rate, tax deterrence sanctions, tax law fairness and psychological costs are significantly affected with the tax non-compliance behaviour of SMEs whereas internal cost is not significantly affected with the tax non-compliance behaviour of SMEs. Based on the findings, it is important that the Inland Revenue Department of Sri Lanka should rethink the tax laws and tax administration that is currently adopted in Sri Lanka and make necessary amendments to legislative and administrative measures to maximize the tax revenue. Furthermore, tax audits should be made more efficient and effective. Generally, the Inland Revenue Department will call taxpayers for a tax audit on a random basis. However, this selection should be done on a specific basis and not at the discretion of the tax officers. The Inland Revenue Department can implement a mandatory tax audit requirement for taxpayers who are crossing specified minimum criteria such as revenue, profit before tax and number of employees etc. The findings have an important impact on establishing the measures, policies and initiatives to address or minimize non-compliance by SMEs and thereby enhance tax revenue collection.

GOVERNMENT BUDGET: ECONOMIC TOOL OR FAIRYTALE?

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The Constitution of Sri Lanka in Article 148 specifies that "Parliament shall have full control over public finance…." The Parliament exercises its control over finances by approval of the budget. The budget authorizes the executive to spend and collect revenues within a given framework. It is one of the main forms of parliamentary control over the executive.

Ideally, the budget should reflect the policies and objectives of the Government which should mirror the choices and aspirations of the people. The Government should have sound fiscal policies relating to revenues, expenditures, and borrowing to achieve macroeconomic stability and growth. The budget is the most potent instrument of the Government in carrying out its policies.

The Prime Minister recently announced that, he will be presenting an interim budget for the year 2022. In Sri Lanka, there is great enthusiasm surrounding the reading of the budget each year, to analyse the revenue proposals. However, there is a general apathy towards analyzing whether the budget estimations for the previous year have been achieved and even if they are not, it hardly raises an eyebrow. This lack of accountability and follow through in the process has allowed the executive and administrators to sometimes overstep their budgetary allocations and it leaves greater discretion for the executive outside parliamentary control.

Fiscal stabilization, distribution or allocation objectives can be achieved either through tax policy or through public expenditure policy. Therefore, both aspects need to be reviewed in tandem since policy objectives can be achieved through direct spending or through tax expenditure. Therefore, public interest and debate on government expenditure is also crucial to ensure that the public finances are spent to achieve the policy objectives enunciated by the policy makers.

Budgeting in a crisis

The IMF has issued a series of guidelines on how to manage the economy for member countries post the pandemic. The article released on 29th June 2020 focuses on "Budgeting in a crisis". Given that the resources are limited in a crisis, it is important to ensure sustainable spending over an unforeseeable timeframe. Therefore, greater focus should be given to priority sectors like health and energy. The non-priority sectors also need to play their part in that their support is needed to contribute towards the larger part of the Government's savings during this period of turmoil.

It is also necessary to assess the feasibility of the spending budgets. The Ministry of Finance needs to closely work with the line ministries and have detailed discussions about how they hope to use the taxpayers' money. The success of the budget depends on how well it is adopted and implemented, and this will only happen when all the stakeholders buy into it. A budget which cannot be practically implemented will not serve any useful purpose.

Uncertainty is inevitable in any budgeting process. This is especially true in the present context where there is high volatility in the internal and external factors. Scrutiny by the Parliament on Government revenue and expenditure is more important in these circumstances to ensure that the necessary checks and balances are maintained and to avoid wastage and mismanagement of public resources. The spending budget should allow a certain amount of flexibility in order to counter the challenging times in our country, but it should not be too fluid where the credibility of the process is undermined. There are certain measures that need to be looked at in addressing some of these issues and to avoid some of the pitfalls;

- Setting up a contingency reserve fund

In Sri Lanka, we are currently going through an economic crisis where one of the biggest challenges is the shortage of foreign currency. This has led to shortages in essential goods which are imported like fuel and gas. The lack of fuel also led to power cuts which was detrimental to continuing economic activity. Given the present context, the Government should set up a contingency reserve fund with annual allocations being made to the fund and strict guidelines on how these funds can be utilised. The situations which trigger the utilization of these funds should be clear and transparent with little room for discretion. A contingency fund of this nature will allow Governments to provide a swift response to sudden shocks and meet dire needs.

The Pacific Island countries like Fiji and Solomon Islands make an annual allocation of funds for a similar contingency fund to counter natural disasters. Sri Lanka too should consider creating such a contingency fund to avoid a crisis like the one we are currently living through.

- Adopt a mechanism to periodically review the budget spending during the year

There is a lack of transparency and accountability on Government revenue and spending which has led Sri Lanka to face a severe economic crisis. The policy makers today in hindsight, admit to having made a serious blunder in abolishing certain taxes, reducing tax rates and granting sweeping tax cuts at the end of 2019. There are several economic scholars who are of the view that the US$ 500Mn payment made in January 2022 in settlement of the sovereign bond should not have been made. However, shouldn't both of these matters have been addressed in the budgeting process by the Government in those respective years. A budget will reflect the amount of money that is available for spending and where the funds will be utilized. Shouldn't the process in itself highlight that certain revenue cuts or certain payments are not sustainable. Why are the representatives of the people not asking these questions at the appropriate time? Is Parliament having full control over public finance as given in Article 148? Why are we trying to close the stable door once the horse has bolted?

This provides clear evidence that the budgeting process is flawed and is not robust enough to address these glaring discrepancies. The Central Bank has a special unit which is tasked with overseeing the budgeting process. However, it either lacks the necessary expertise or the teeth to slash proposals that can be detrimental to the economy. There is also a dearth of information in the public domain for outsiders and professionals to get involved and lobby the Government for better policies and to hold the policy makers accountable for their decisions.

It is recommended that a Central Budget Authority be set up, under the direct supervision of the Parliament. Experts in the field both from within the executive and outside can be accommodated with a clear mandate to guide the budget preparation for a given timeline and to constantly monitor the progress/performance of the executive against the budget. The Governor of the Central Bank, the Secretary to the Ministry of Finance and the Finance Minister himself will be held accountable to the Central Budget Authority. In order to ensure greater accountability and transparency it is also recommended that the performance against the budget be published on a quarterly basis to ensure that the public has access to information readily. Closer budget execution monitoring will facilitate a proper and comprehensive recording of government accounts and fiscal statistics.

- Freezing of budget allocations until completion of specific milestones

The allocation of funds for various line ministries is done based on the requirement submitted by such ministries and depending on the funds available. However, once the funds have been allocated, there is little accountability on how the funds are being deployed and there is poor assessment on whether the specific objectives have been met. Therefore, a certain part of the budget allocation should be frozen until the respective line ministry has achieved certain specific milestones that it has set for itself. This will ensure greater transparency on how the funds are being utilized and it will also hold the respective line ministries accountable to achieve the Government's policy objectives. It will motivate the Government sector employees to attend to the tasks assigned within the set timeline in an efficient manner.

It's a story but not a fairytale

Amid high uncertainty and stress, the best way to bolster confidence among the people is to clearly spell out the Government's strategy in unequivocal terms. Any budget presented in the current circumstances should cover fiscal, economic and social measures with clear goals and objectives. The Budget is an effective tool to communicate the way forward to the people. This will showcase the fact that the Government has a credible strategy to mitigate the present woes of the economy and support economic recovery in the medium to long term.

The Government should clearly explain to the people the present economic situation without window dressing. It is always better to know the truth than to be courted with a lie. Most budget speeches are populist statements that sugarcoat the truth. It is structured more to gain votes than to manage public finances.

Overtime, it is trite law that there should be "No taxation without representation". This has been enshrined in Article 148 of our Constitution, where full control over public finances has been vested with Parliament. This control is exercised by Parliament through the budget. Therefore, the budget should tell us the story about the Government's plan on how it hopes to address the current economic crisis, how it hopes to earn much needed revenue, how it will rationalize Government spending and cost savings and how it plans to get there. We have lived through the fairytale of tax cuts and promises of prosperity with no happy ending. Therefore, what we need is a clear road map on how to reach that light at the end of the tunnel.

NEW TAX LEGISLATIONS

(A) Surcharge Tax

The Surcharge Tax Act No. 14 of 2022 has been certified by the Hon. Speaker on the 08th April 2022. The Surcharge Tax was proposed in the budget speech for 2022 as a onetime tax of 25% on persons and companies with taxable income over Rs. 2,000 million for the year of assessment 2020/21. The expected revenue to the Government from this tax is Rs. 100 billion.

The Surcharge Tax Act passed in Parliament imposes this tax

- Any individual, partnership or company, whose taxable income calculated in accordance with the provisions of the Inland Revenue Act, No. 24 of 2017 (IRA), exceeds LKR 2 Bn for the year of assessment 2020/2021. [In the case of partners, the income of a partner derived from a partnership shall not be considered when calculating the taxable income of such partner as an individual if the tax has been paid by the partnership on such taxable income.]

- Each company of a group of companies, of which the aggregate of the Taxable Income of all subsidiaries and the holding company in that group of companies, calculated in accordance with the provisions of the IRA exceeds LKR 2 Bn for the year of assessment 2020/2021 irrespective of the taxable income of any one of such companies not exceeding LKR 2 Bn.

The law provides that when calculating the aggregate of the taxable income of a group of companies, any companies in the group which have a Nil amount of taxable income due to current year losses or brought forward losses will not be taken into account.

The tax is to be calculated at the rate of 25% on the taxable income for the year of assessment 2020/21. When calculating the tax, in the case of group of companies, 25% is applicable on taxable income after deducting the gains and profits from dividends received from a subsidiary which is part of such taxable income of each such company, for such year of assessment.

The Surcharge Tax Act specifies that this tax will be deemed to be an expenditure in the financial statement relating to the year of assessment commencing on 01st April 2020. CA Sri Lanka has issued a Statement of Alternative Treatment (SoAT) on Accounting for Surcharge Tax under the Surcharge Tax Act which is applicable for all companies which are liable to pay this tax. As this is to be recognized as an expenditure relating to the year commencing 01st April 2020, it shall be recorded as an adjustment to the opening retained earnings reported in the Statement of Changes in Equity on the first day of the previous financial year (e.g. 1 January 2021 for a December year-end entity / 1 April 2021 for a March year-end entity) with necessary disclosures.

The surcharge tax paid cannot be deducted in computing the taxable income for income tax purposes. Further, no deduction will be allowed in calculating the Value Added Tax on the supply of financial services either.

Compliance obligations

The payment of the tax is to be made to the Commissioner General of Inland Revenue in two equal installments as follows;

- On or before the 20th April 2022 and
- On or before 20th July of 2022

Every taxpayer liable for the Surcharge Tax must file a Return prior to 20th April 2022 in the form specified by the Commissioner General. Where the taxpayer has defaulted on the tax, he will be treated as a defaulter and an assessment can be made against such taxpayer. No assessments can be issued under the Surcharge Tax Act after 31st December 2024 other than on making any amended assessment based on a decision of objection or appeal. Provisions of the Inland Revenue Act No. 24 of 2017 will apply in relation to the administration of the tax.

(B) Value Added Tax

The Value Added Tax (Amendment) Act No. 13 of 2022 has been certified by the Hon. Speaker on the 31st March 2022.

VAT on financial services

The VAT rate on Financial Services has been increased from 15% to 18% with effect from 1st January 2022. The proposal to increase the VAT rate on financial services in the budget is expected to raise Rs. 14 billion as tax revenue to the Government. The budget speech specified that the increase in the VAT rate was only to be done for a period of one year from 01st January 2022 to 31st December 2022. However, the Amendment Act passed in Parliament does not recognize such expiration timeline of 31st December 2022. Further, the budget speech also indicated that this tax is not be passed on to the customer but should be borne by the financial institution. However, on provisions have been made in relation to this in the Amendment Act.

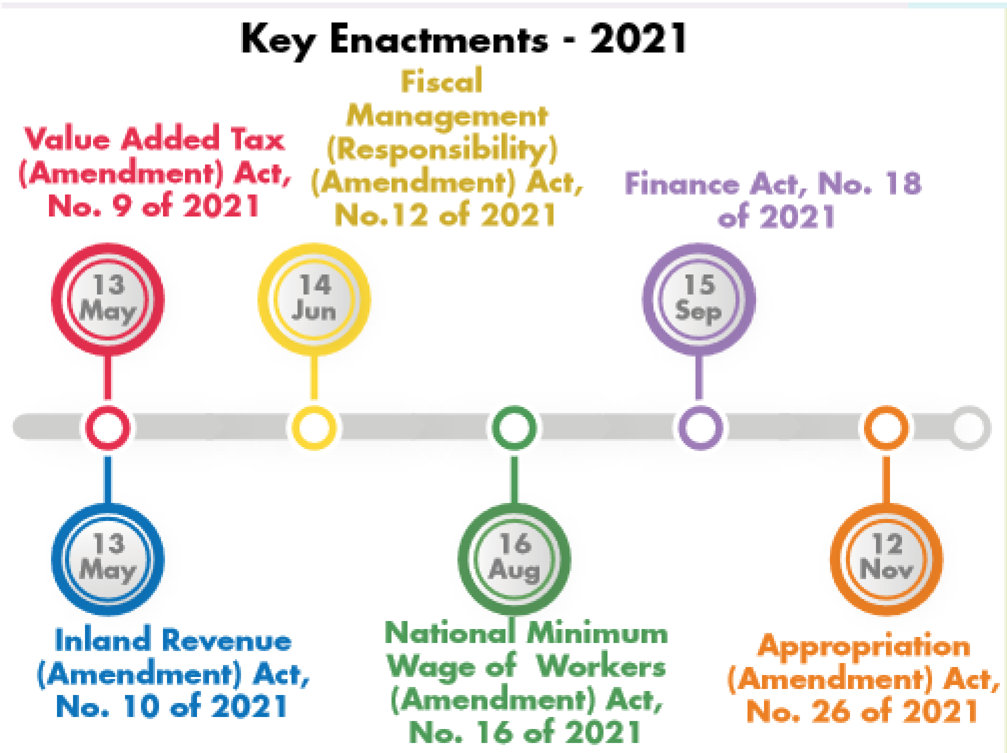
Exemptions

1. On medical equipment, machinery, apparatus, accessories and parts thereof, hospital furniture, drugs and chemicals donated to a government hospital or the Ministry of Health for the provision of health services to address any pandemic or public health emergency, approved by the Minister assigned the subject of Finance on the recommendation of the Secretary to the Ministry of the Minister assigned the subject of Health on or after 01st January 2022.

TAX FACTS – CBSL ANNUAL REPORT 2021

Tax cuts

- During the year 2021, the commitment of the Government to maintain a low tax regime to promote swift economic recovery and growth resulted in lackluster performance in Government revenue.
- The tax adjustments that were announced in November 2019 and other announcements made in January 2020 and April 2021 were enacted as legislations in 2021.



- Although the aim of the aforementioned policies was to revive the economic activities faster, and in turn, boost the revenue flows, the slow paced recovery in economic activities adversely affected higher Government revenue in 2021.

Tax amnesty

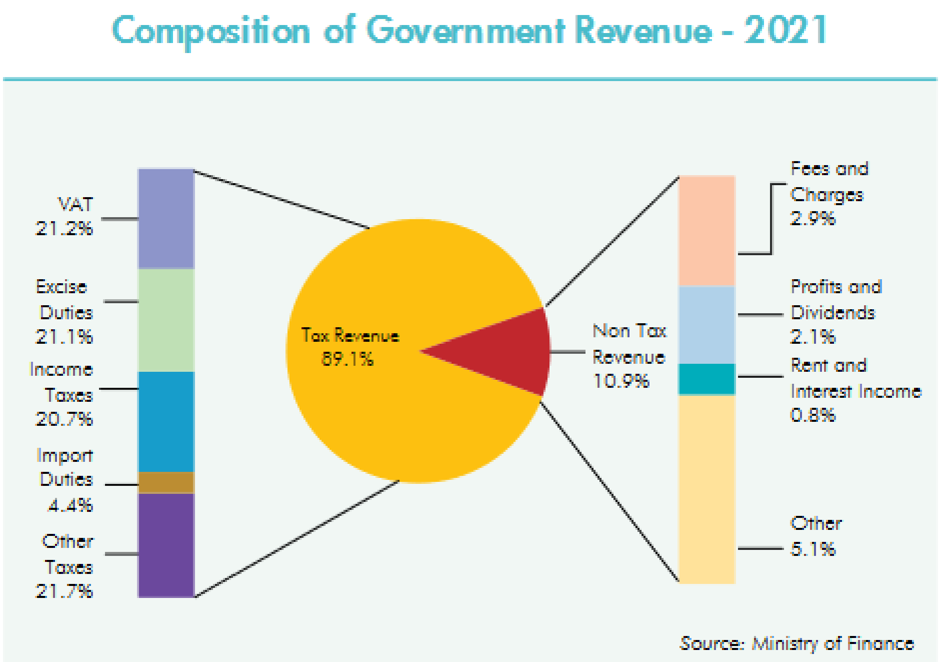
- During the year 2021 and early 2022, the Government attempted to introduce several measures aiming at reducing tax evasion and minimizing complexities in the tax administration.
- The tax amnesty legislated under the provisions of the Finance Act, No 18 of 2021 provides for persons to voluntarily report their undisclosed taxable supplies, income, and assets for any taxable period ended on or prior to 31 March 2020, or in a return of income for any year of assessment ended prior to 31 March 2020.

- In the absence of strong enforcement measures, revenue generated from tax amnesty was limited to Rs. 174.6 million in 2021.
- Although tax amnesties are implemented to meet short term revenue shortfalls, such policies generally do not create desirable outcomes as reflected in realized data, and these policies may disincentivize law abiding taxpayers and encourage corruption and even, money laundering.

Tax administration

- Mandatory use of a Taxpayer Identification Number (TIN) in all tax related source documents.
- E-filing made compulsory for all limited liability companies.
- Revisiting and simplifying the tax structure and strengthening the tax administration remain imperative at present to address the notable decline in government revenue and improve government finance on a long term basis.

Government revenue



- Government revenue recorded a sluggish growth in 2021 yielding the historically lowest tax to GDP ratio amidst the low tax regime instituted since late 2019.
- Tax revenue as a percentage of GDP, which stood at a low level of 8.1% in 2020, further declined to 7.7% during 2021.
- Government revenue as a percentage of GDP declined to a record low since independence, owing to the impact of the continuation of the low tax regime, import restrictions imposed to ease external sector pressure, and the modest pickup of the economy.

- In 2021, in nominal terms, government revenue grew by 6.5%, year-on-year, to Rs. 1,457.1 billion, benefitting mainly from higher tax revenue collection from VAT, income taxes, PAL and CESS.
- ***Income tax* -** Revenue from corporate and non corporate income taxes increased notably to Rs.273.6 billion in 2021 compared to Rs.228.3billion recorded the previous year, indicating the recovery of economic activities in 2021 compared to the preceding year and improved performance mainly in corporates. As a percentage of GDP, revenue generated from income taxes remained at 1.8 per cent in 2021, broadly unchanged from 2020.
- ***VAT*** - Revenue collection from VAT increased to Rs.308.2 billion in 2021 compared to Rs.233.8 billion in 2020. As a percentage of GDP, VAT revenue increased to 1.85 in 2021 from 1.6% in 2020.
- ***Excise duty*** – Revenue collection from excise duties declined to Rs. 306.9 billion in 2021 from Rs. 322.0 billion in 2020, while as a percentage of GDP, excise duties mobilization declined to 1.8% in 2021 companied to 2.1% in the preceding year. This was mainly due to the continuation of restrictions on motor vehicle imports that were imposed in view of foreign exchange liquidity issues in the country.
- ***Customs duty*** – Revenue from Customs duties declined to Rs.64.3 billion in 2021, from Rs. 114.2 Bn recorded in 2020. Apart from the import restrictions, reduction of the Customs duty rate from 30% to 15% on selected items that was implemented in November 2020 in line with the simplification of the Customs duty structure, also contributed to the decline in revenue generated from international trade activities.
- ***Special Commodity Levy (SCL)*** – SCL also declined from 32.5% to Rs. 55.8 Bn in 2021 compared to Rs. 82.7 Bn in 2020. Import restrictions on dried fish, big onions and potatoes, and the imposition of duty waivers on salt, rice, desiccated coconut and maize caused the decline in revenue mobilization from SCL.
- ***PAL and CESS*** – Revenue from PAL increased to Rs. 154.1 Bn in 2021 from Rs. 115.4 Bn in 2020, while revenue from CESS levy increased by 53.2% to Rs. 75.5 Bn in 2021 over 2020. Increase in rates on CESS levy for selected items in line with the simplification of the Customs duty structure in November 2020, contributed to the rise in revenue collection from CESS levy.

Summary of Government Revenue

Item	2020 (a)	2021 (b)
	Rs. million	
Tax Revenue	**1,216,542**	**1,298,019**
Income Taxes	268,249	302,115
VAT	233,786	308,213
Excise Taxes	321,932	306,861
Import Duties	114,183	64,339
Other Taxes	278,392	316,490
Non Tax Revenue	**151,417**	**159,052**
Total Revenue	**1,367,960**	**1,457,071**
	As a Percentage of GDP (c)	
Tax Revenue	**8.1**	**7.7**
Income Taxes	1.8	1.8
VAT	1.6	1.8
Excise Taxes	2.1	1.8
Import Duties	0.8	0.4
Other Taxes	1.9	1.9
Non Tax Revenue	**1.0**	**0.9**
Total Revenue	**9.1**	**8.7**

(a) According to the Ministry of Finance, the fiscal sector statistics of 2020 have been adjusted as announced in the Budget Speech for 2020.
(b) Provisional
(c) For 2020, revised GDP estimates were used, as released by the Department of Census and Statistics on 29 March 2022.

Source: Ministry of Finance

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