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CA SRI LANKA TAX JOURNAL

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CONTEMPORARY ISSUES IN TAXATION

Message from the Chairman of the Faculty of Taxation

I have the honor of contributing this message to the Tax Journal, a publication of CA Sri Lanka, as the Chairman of the Faculty of Taxation.

William F. Buckley Jr. once said, "I would like to electrocute everyone who uses the word "fair" in conjunction with income tax laws."

On the 2nd and 3rd of September 2022, the Tax Faculty of CA Sri Lanka held its first-ever Tax Symposium as a first step toward such improvements. The primary goal of this event is to provide a forum for all stakeholders to debate current concerns related to the execution of tax policy in Sri Lanka. The Ministry of Finance has been informed of the highlights of the proposals and issues raised as a result of this highly successful event, in an attempt to aid them create a stronger and fair policy framework.

The results of the Tax Symposium are included in this issue of the tax journal. I invite all members who are interested to offer their ideas and opinions to improve a fair tax system in this nation.

Tishan Subasinghe

Editor's Note

The Tax Faculty of CA Sri Lanka conducted its first ever tax symposium on the 2nd and 3rd of September 2022. The objective of this event was to provide a platform for all the key stakeholders of the tax system - the taxpayers, the tax administrators, the tax practitioners and the policymakers to engage in an open discussion on what changes we need to make in order to revamp our tax system to make it more efficient and effective. The points highlighted at this event have been documented and presented to the Ministry of Finance, where a team from the tax faculty met the Secretary to the Treasury in person and explained the proposals. The learning from these sessions have been documented in the tax journal in this issue.

The current international tax framework is underpinned on the concept of a physical presence in a foreign jurisdiction, and the foreign jurisdiction derives the right to tax revenue based on the physical presence of a business. However, with the advancement in technology, there are many businesses that sell goods and services in foreign jurisdictions without having any physical presence in such country. This has prompted the OECD to devise a plan to combat these tax loopholes and the solution has been explained as Pillar 1 and Pillar 2. Our authors have provided a comprehensive write up about these solutions. Sri Lanka, however, is not a party to this initiative and has indicated that it needs more time.

Post Covid-19, we need to re-visit the tax compliance obligations of taxpayers and the appetite and capacity to pay taxes given the stresses placed on the economy by the global pandemic. We have a member of the revenue administration looking at this topic in a broad and insightful manner, to both understand and address tax compliance issues in these challenging times.

This issue is a combination of articles which provide a positive outlook from a tax perspective on how Sri Lanka can address issues in the tax system and how we can fix these issues to ensure that the taxes in the country are aligned to the needs of the people and allow citizens to enjoy the benefits of the collective revenue and not be overburdened by the tax costs. In the backdrop of the economic crisis in the country, these articles can be used as a catalyst to bring the change required to the tax system in our country to ensure that we engage in the reforms that are needed to grow as an economy.

DINUSHA RJAPAKSE

Editor

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SETTING THE STAGE FOR TAX REFORMS: MACROECONOMIC CONTEXT IN SRI LANKA

The first session of the annual Tax Symposium organized by CA Sri Lanka on 2nd September 2022 was to provide the context for the discussion on how the tax system in Sri Lanka can be improved. This article is a summary of the presentation made by Mr. Dhananath Fernando – Chief Operating Officer, Advocata Institute. The expected outcome of this event is to identify the policy errors done previously and to analyse the how to overcome the economic challenges we are currently facing.

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Why is Sri Lanka poor?

Sri Lanka is a country rich in resources. However, the Sri Lankan economy is poor. Wealth is a state of mind. Being wealthy is not just having a lot of money. Rather, being wealthy is when you have the ability to recreate wealth. A reason for Sri Lanka being a poor nation is because Sri Lankans are not able to recreate more wealth with the wealth they have. Even though Sri Lanka has resources, we do not know how to multiply/ recreate wealth. Consequently, the country has been poor for a long time.

What happened to us?

In the past Sri Lanka in our elections have always auctioned non-existing resources. This has contributed to fiscal profligacy.

An auction of non existing resources

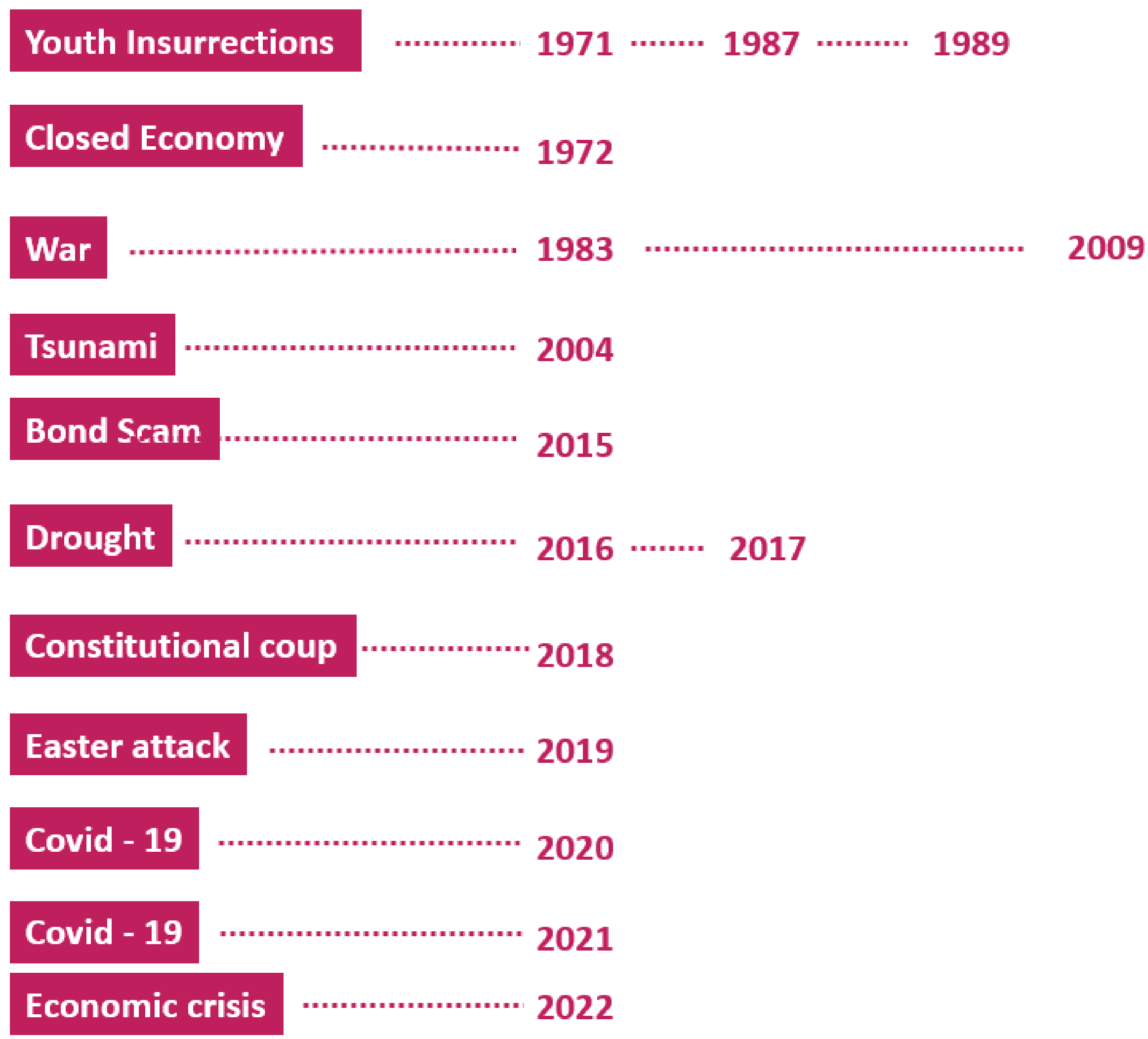
Election	Promise
1952	The UNP promised not to increase the price of rice as it was the staple diet of the public, a quarter of rice will be 25 cents.
1970	PM Sirimawo promised to bring rice from the moon if needed.
1977	President J.R. Jayewardene promised… that all citizens will be provided with 8kg of grain every month.
1994	Former President Chandrika Kumaratunga promised that she will provide bread at Rs. 3.50 when the market price was Rs. 5.00
2015	In order to provide urgent relief to the debt-stricken the salary of public servants will be increased by Rs. 10,000.
2019	Gotabaya Rajapaksha announced that he would increase the daily wage of a plantation worker to Rs. 1,000. This was countered by Sajith Premadasa offering to increase it to Rs. 1,500. Gotabaya Rajapaksha stated that, if elected, we should give free fertilizer to the paddy farmers.

Findings from Academic Research

- Proportionate electoral systems suffer from deficit bias compared to majoritarian systems (Battaglini 2010,14).
- Proportionate systems accumulate more debt than majoritarian systems (Roubini and Sachs 1989).
- Presidential systems have smaller governments than proportional systems.
- Parliamentary systems that increase government spending during recession are unlikely to reverse it during economic expansions.

The promises made cannot be achieved unless, the country is in a position to re-create wealth. Further, when the political leadership makes statements of this nature, it creates a culture of entitlement among the people. The electoral system is a reflection of the people of the country. The electoral system in Sri Lanka needs to be reformed.

Sri Lanka has had many challenges that has disrupted the smooth journey of our country;



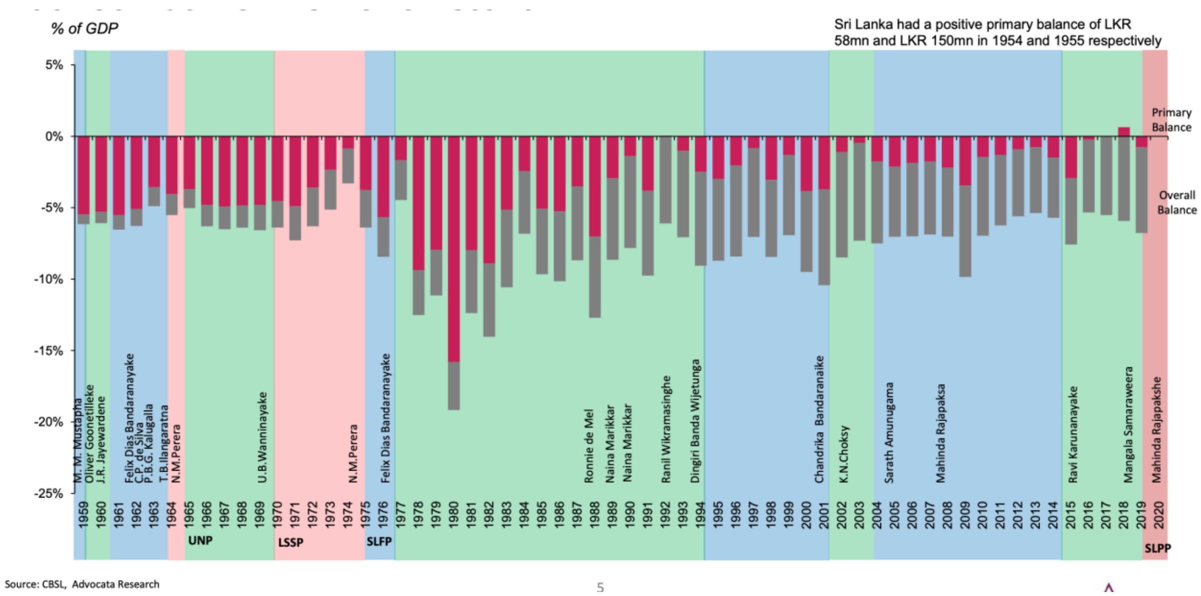
Even though we embraced an open economic policy in 1977, the other reforms required to facilitate this such as labour reforms were not implemented to support this change in economic policy.

Measuring our economy

The state of an economy is measured under the following heads;

I. Primary Balance

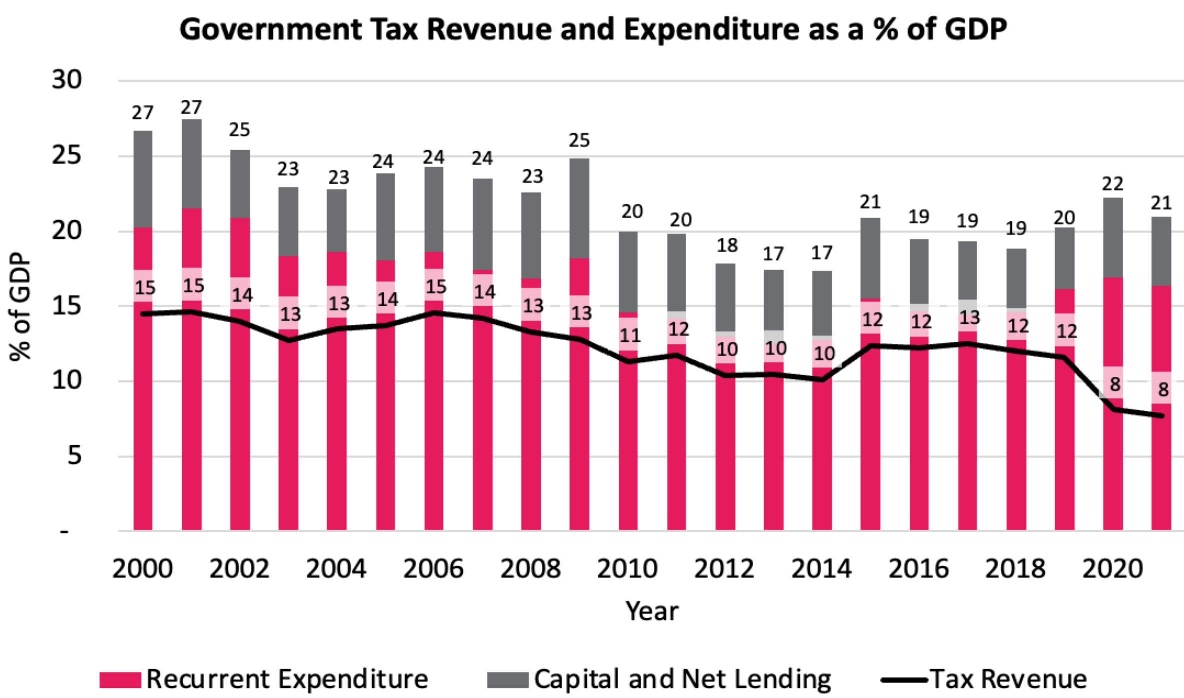
The primary balance = Income – (Expenditure + debt servicing)



The concept of fiscal conservatism is non-existent in Sri Lanka as statistics show that the Primary Balance of Sri Lanka is in deficit since 1959 except in 2018. According to the recent IMF statement, they insisted Sri Lanka to have a 2.3% primary balance by 2024-2025 in order to overcome the current economic crisis.

Apart from external factors, financial management in Sri Lanka has also not been well managed.

II. Tax revenue to the Government

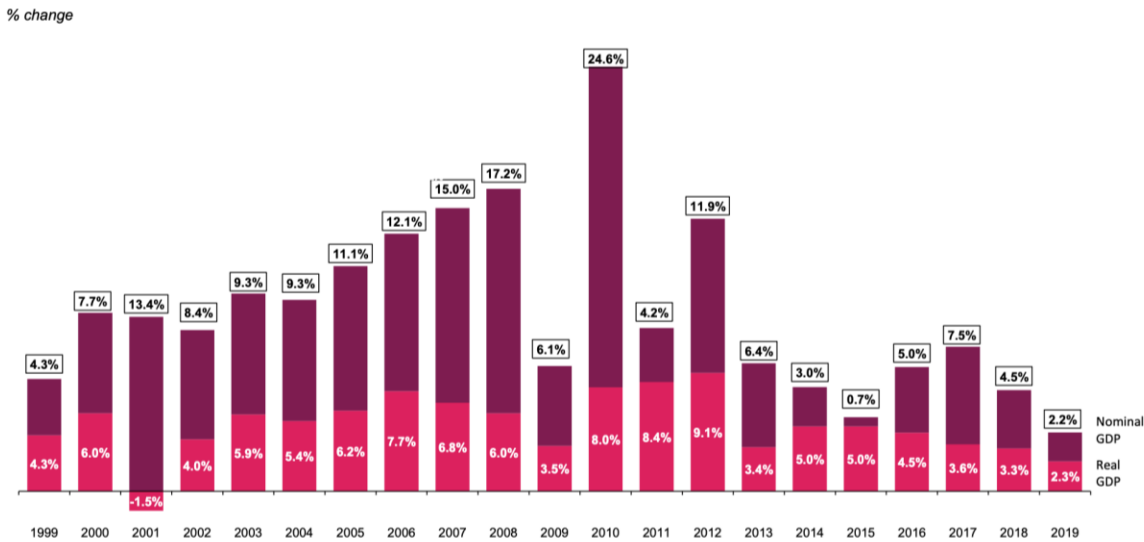


Based on the data the revenue is consistently lower than the expenditure. The present Tax to GDP is 8% which is the lowest in the world. With a trajectory like this with ever declining revenues, Sri

Lanka is not in a position to achieve economic growth. If we continue with the same trend, the future for Sri Lanka looks very bleak.

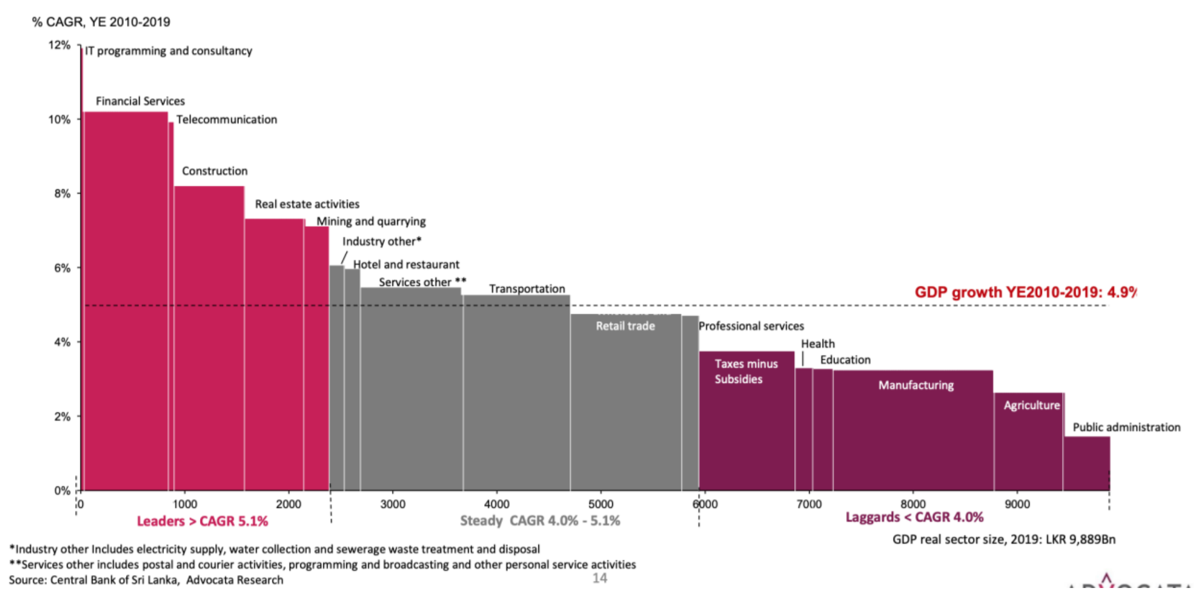
III. Economic Growth

Sri Lanka is currently reporting a negative growth of 8.7%. Based on this Sri Lanka will still be in the same economic position it was in 2016 while other countries have moved forward, even with Covid-19.



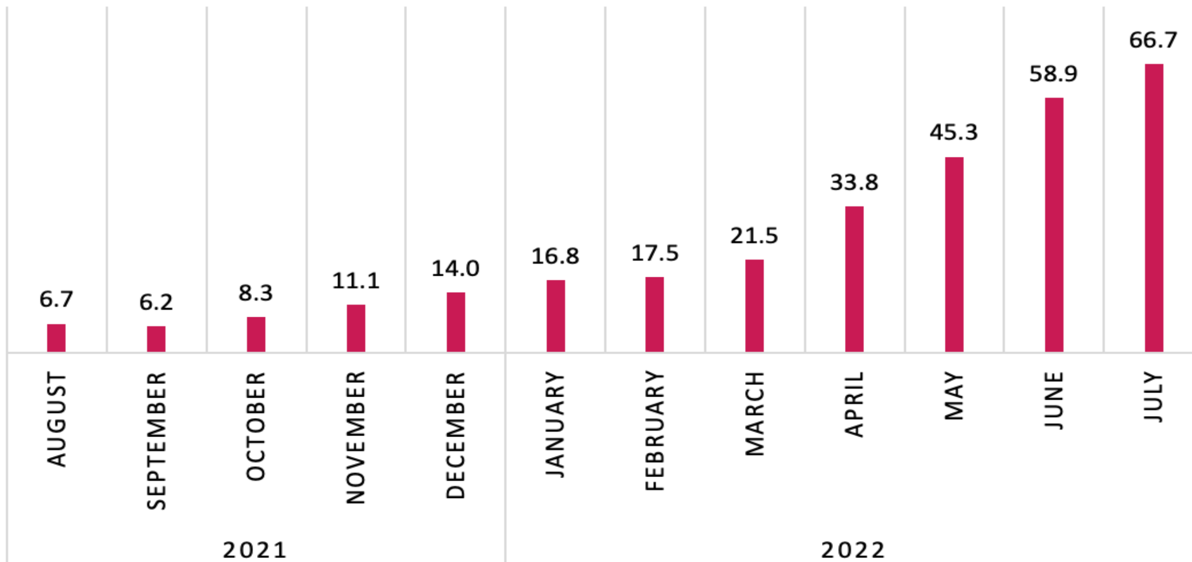
The real GDP in Sri Lanka is declining. The systems and economic engine are not supporting a growth trajectory. We have remained stagnant over the past few years.

When looking at the sectors that are driving economic growth, it is evident that the manufacturing and agriculture sectors are not contributing significantly.

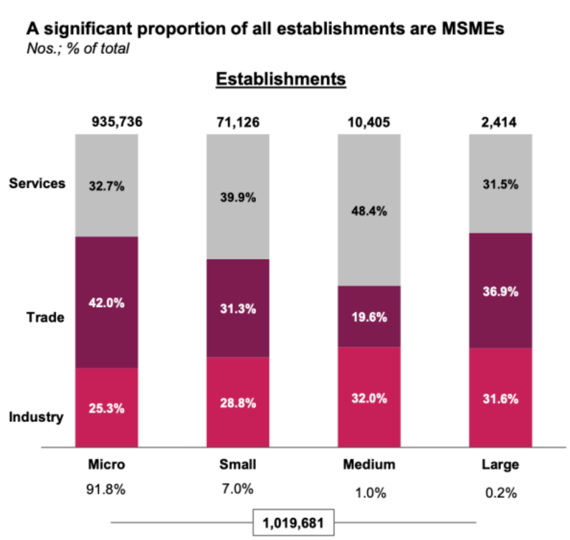


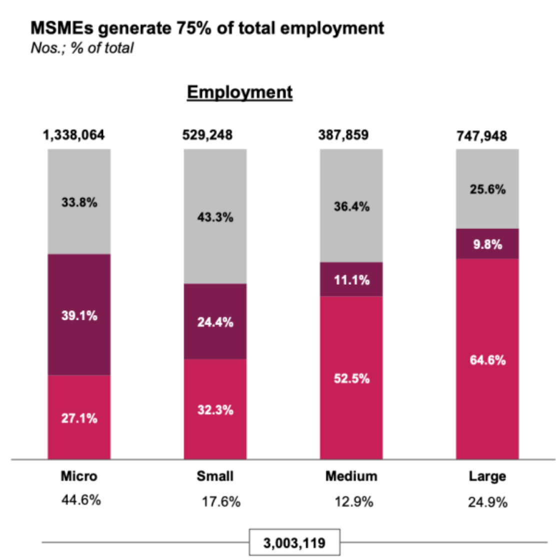
It is the service sector that makes a significant contribution towards economic growth in our country. Financial services, telecommunication, construction and real estate activities have been performing well.

IV. Inflation



The NCPI (National Consumer Price Index) is at record high. Food inflation is at about 80%. Inflation at these rates is adversely impacting the micro and small enterprises and the poor people of our country.



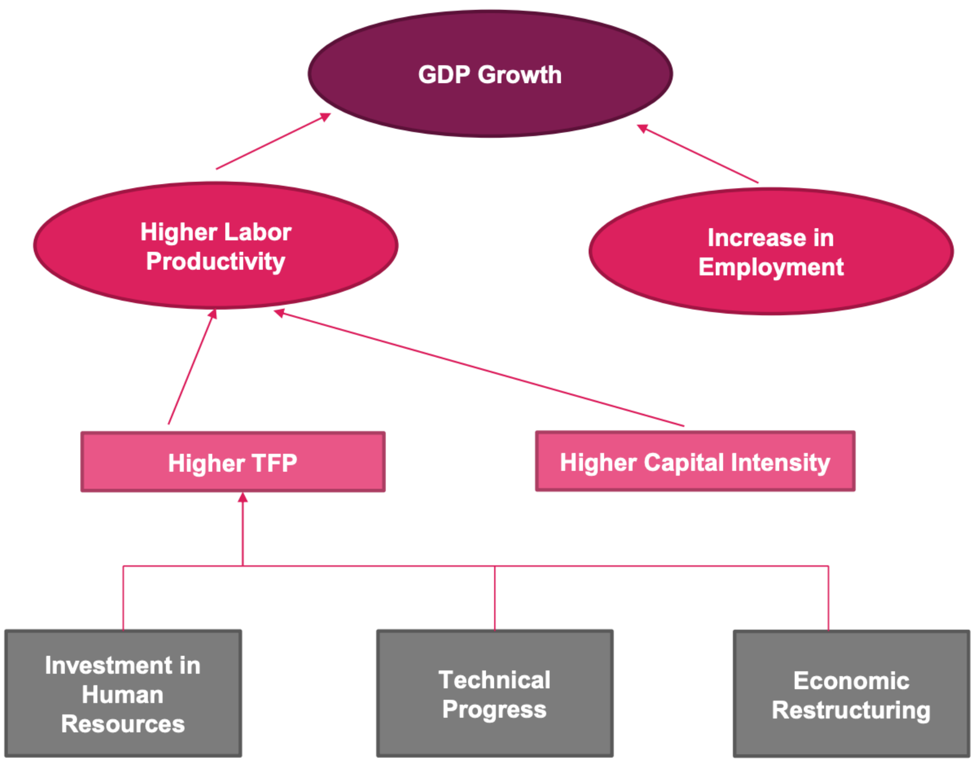


About 99% of our economy are micro, small and medium enterprises. Further, about 75% of employment is provided by the MSME sector whilst only 24% is provided from large enterprises. Therefore, with high inflation rates, these MSMEs are severely affected. In a bid to curb inflation, the interest rates are going up which will adversely impact MSMEs and with the economy contracting, these enterprises will find it difficult to survive.

In these circumstances, MSMEs will have to scale down operations or shut down, which will lead to unemployment which in turn will lead to social unrest. Henry Hill said, "the history of people is the history of inflation". With increase in inflation, there is higher tension among the people which leads to civil unrest.

What we can do….

Being optimistic is the key for economic revival. There is progress on discussions with the IMF as Sri Lanka has entered into staff level agreements to stabilize the economy. Whist stabilising the economy, it is also important that growth takes place as well.



1. Increase Productivity

The productivity of enterprises in Sri Lanka is low because labour markets, labour regulations, capital markets, financial system regulations do not support productivity.

Coconut
Arable land (2014) - **20.6%**
Domestic production (Mn. Nuts) - **2,623**
Domestic consumption (Mn. Nuts) - **1,794**
Avg. number of nuts/tree (per year) - **62**
Best practice (Ha. Kg.) - **100**

Rubber
Arable land (2014) - **12.2%**
Domestic production (Mn. Kg.) - **82.6**
Domestic usage (Mn. Kg.) - **58.6**
Average yield (Ha. Kg.) - **800**
Best practice (Ha. Kg.) - **2000**

Paddy
Arable land (2014) - **32.1%**
Average yield (Ha. Kg.) - **4,443**
Best practice (Ha. Kg.) - **6,000**

Tea
Arable land (2014) - **10.7%**
Domestic production (Mn. Kgs) - **304**
Exports volume (Mn. MT) - **282**
Export value (Mn. LKR) - **231,750**
Average yield (Ha. Kg.) - **800-850**
Best practice (Ha. Kg.) - **2,500**

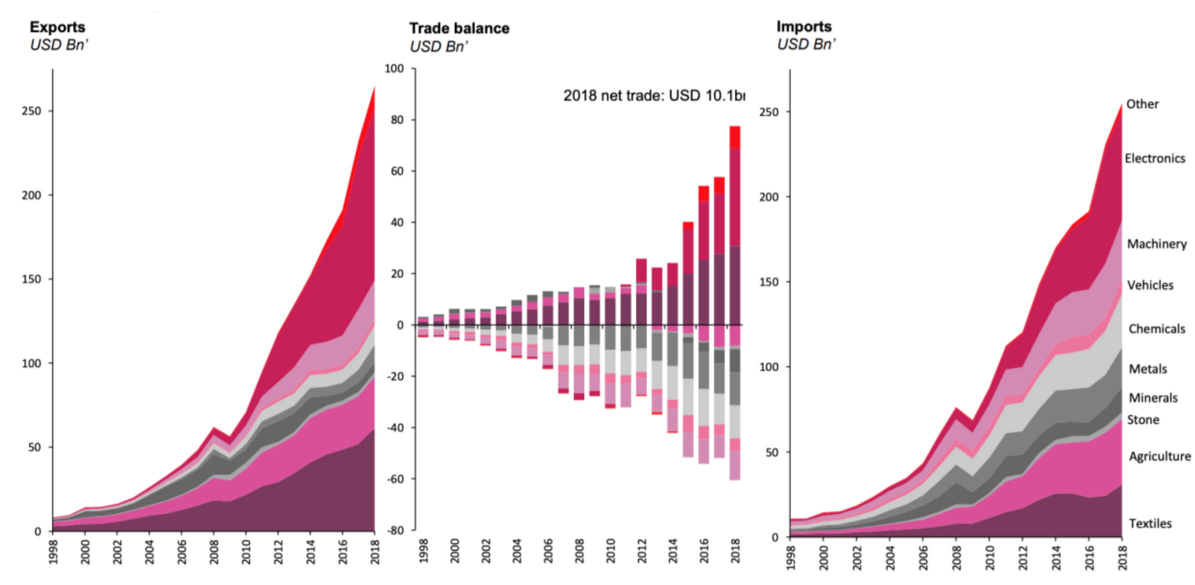
Dairy
Number of milking cows - **423,580**
Fresh milk production (Liters Mn.) - **477**
Avg. milk production (Liters per cow per day) - **5**
Best Practice (Liters per cow per day) - **25**

Based on the data, the productivity in Sri Lanka is very low. That is why Sri Lanka is considered as a poor nation with immense resources.

2. Increase Trade

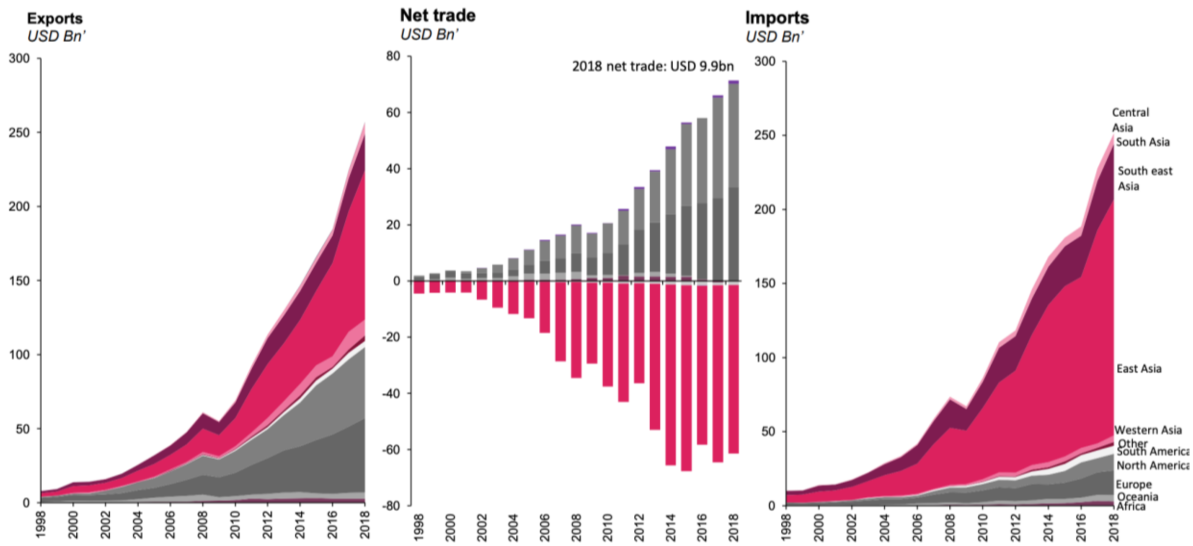
Trade plays a massive role in increasing productivity. There should be a balance between imports and exports. For example, if we take Vietnam, imports drive their exports. Imports make a country competitive. Expand the import market to export better. Only when a market is competitive can the country access global markets. The best example for this is Vietnam.

Trade dynamics: VIETNAM



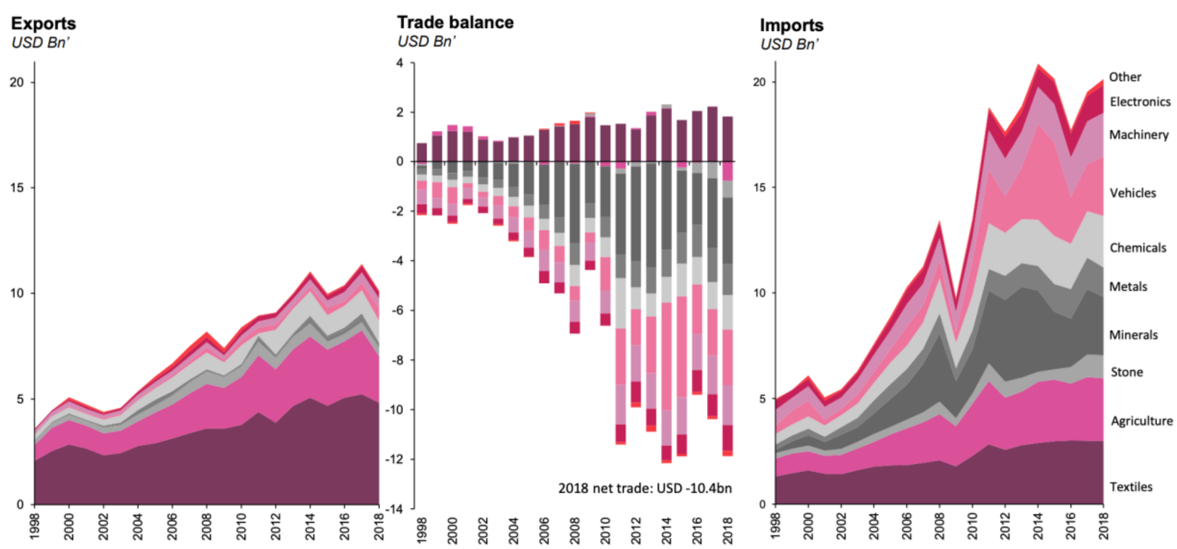
Exports in Vietnam from about USD 5 bn in 1998 exploded to about USD 250 bn in 2018. The imports on the other side also increased. Imports and exports are two sides of the same coin. The imports are what drives the exports of the country. For example, Vietnam is importing a large amount of electronics and it is also exporting a large amount of electronics. Imports make the country competitive. If the country is managing its inputs well, then it is in a better position to compete in the global market. It is only then that the country can access global markets. If a country is adopting a protectionist policy on imports, then it is restricted to the domestic market.

Trade direction: VIETNAM



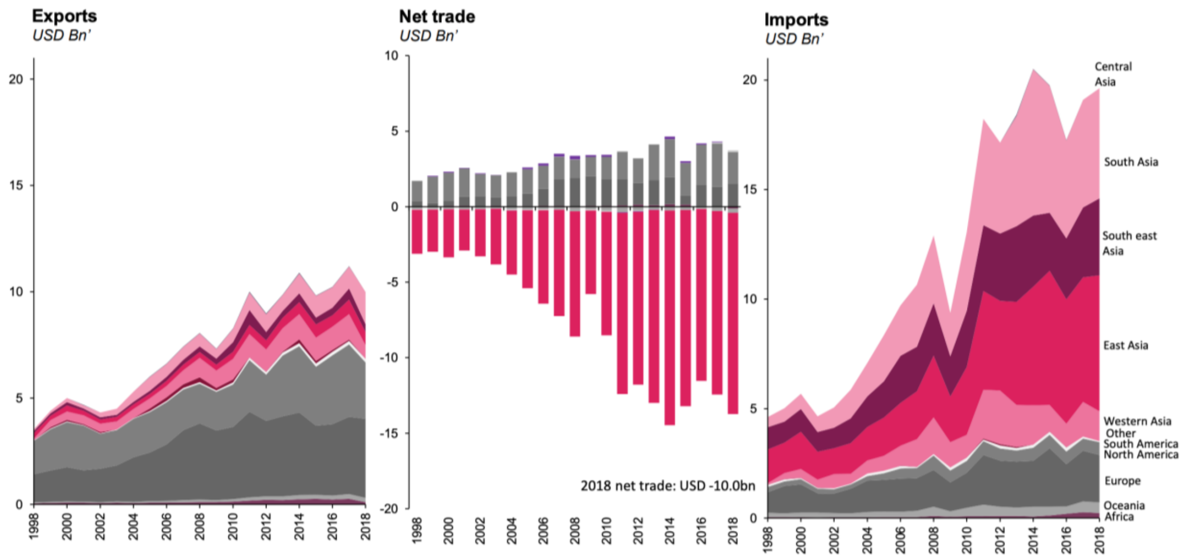
Based on the data, Vietnam's exports are heavily concentrated on the east asian markets. There is a growing trend in these markets, where the population of certain countries are large.

Trade dynamics: SRI LANKA



Exports in Sri Lanka have moved from about USD 5 bn in 1998 to about USD 10 bn in 2018. Therefore, even though Vietnam and Sri Lanka were at around the same place in 1998 Vietnam's exports have grown exponentially.

Trade direction: SRI LANKA



Sri Lanka has focused its exports mainly to the European union and America. We have not ventured out to new markets, and we are not aggressively seeking out opportunities in other markets.

Trade Agreements

Sri Lanka must increase trade agreements between countries which will be beneficial to Sri Lanka. There are groups which lobby against these but without entering into trade agreements, we cannot access new markets. Given below is a comparison of trade agreements that are operational in Thailand, Vietnam and Sri Lanka.

Thailand

- ASEAN-People's Republic of China Comprehensive ASEAN-Hong Kong, China FTA (2019)
- Thailand-Chile FTA (2015)
- Thailand-Peru FTA (2011)
- ASEAN-India Comprehensive Economic Cooperation Agreement (2010)
- ASEAN-Australia and New Zealand FTA (2010)
- ASEAN-Japan Comprehensive Economic Partnership (2008)
- Japan-Thailand Economic Partnership Agreement (2007)
- ASEAN-Republic of Korea Comprehensive Economic Cooperation Agreement (2007)
- Australia-Thailand FTA (2005)
- New Zealand-Thailand Closer Economic Partnership Agreement (2005)
- Economic Cooperation Agreement (2005)
- People's Republic of China-Thailand FTA (2003)
- Laos-Thailand Preferential Trading Arrangement (1991)
- ASEAN FTA (1993)

Vietnam

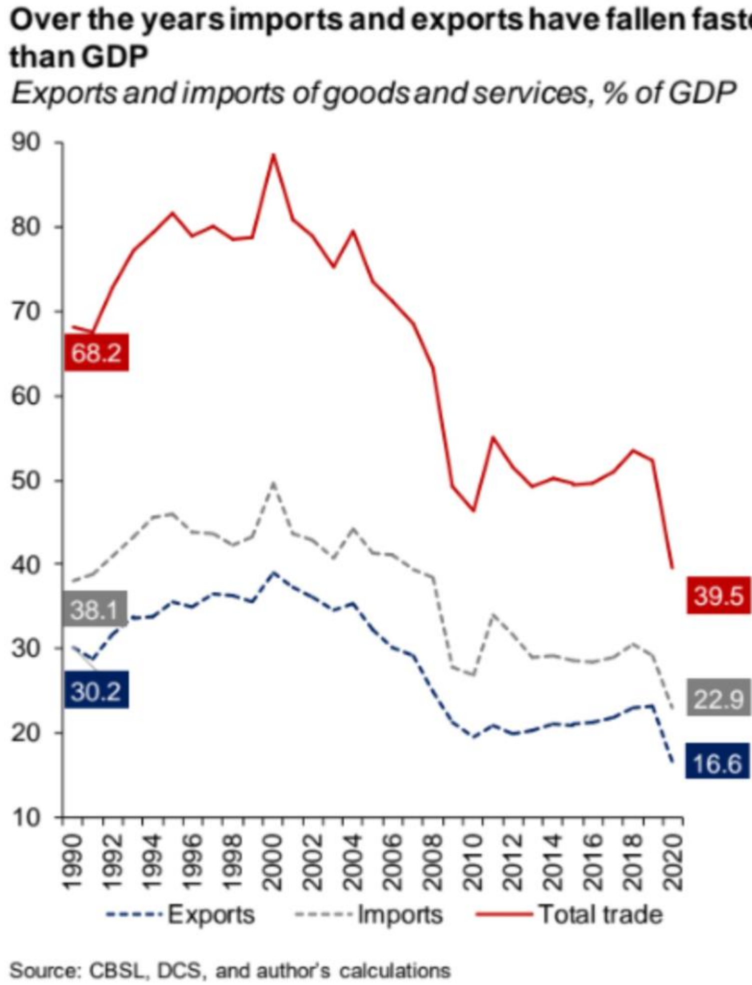
- ASEAN-Hong Kong, China FTA (2019)
- Comprehensive and Progressive Agreement for Trans-Pacific Partnership (2018)
- Viet Nam-Eurasian Economic Union FTA (2016)
- Japan-Viet Nam Economic Partnership Agreement (2016)
- Republic of Korea-Viet Nam FTA (2015)
- Viet Nam-Chile FTA (2012)
- ASEAN-Australia and New Zealand FTA (2010)
- ASEAN-India Comprehensive Economic Cooperation Agreement (2010)
- ASEAN-Japan Comprehensive Economic Partnership (2008)
- ASEAN-Republic of Korea Comprehensive Economic Cooperation Agreement (2007)
- ASEAN-People's Republic of China Comprehensive Economic Cooperation Agreement (2005)
- ASEAN FTA (1993)

Sri Lanka

- Sri Lanka-Singapore FTA (2018)
- South Asian FTA (2006)
- Pakistan-Sri Lanka FTA (2005)
- India-Sri Lanka FTA (2001)
- Asia-Pacific Trade Agreement (1976)

Exports and imports are both declining

There is a common misconception that Sri Lanka is importing more and more over the years. However, the statistics show that both imports and exports are declining in Sri Lanka.



Sri Lanka needs to expand its trade in order for the economy of our country to be on a growth trajectory. Since we are cutting down on imports, we are not being competitive in the global market. Given the current foreign currency shortage, this seems a good measure. However, this cannot be done in the long term if Sri Lanka is to achieve economic growth.

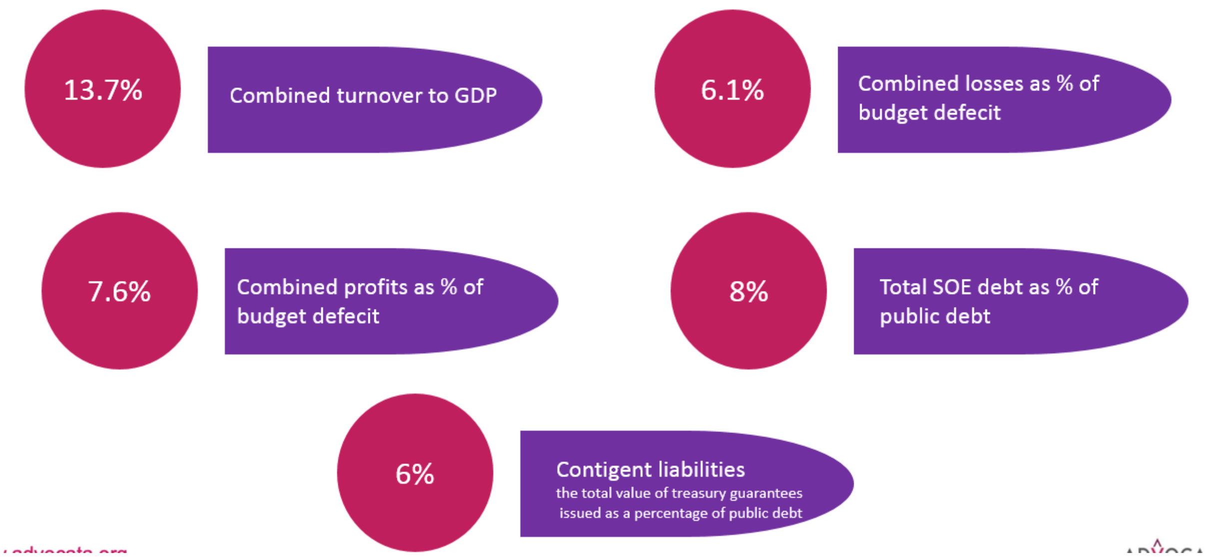
We cannot however, continue to import the same goods. If you look at the past, even before the economic crisis, when we had a civil war and other externalities, we had high tariffs on imports, and it is one of the main revenue sources to the Government. As a result, we have become a more closed economy.

Trade reforms need to be done in order to improve trade with other countries and the export sector will have to contribute significantly to the economic growth of the country.

State Owned Enterprises (SOE) Reforms

Given the current situation of the SOEs, without reforms to SOEs we are not in a position to move forward as an economy.

SOE performance indicators



To understand the impact of this on our economy let us look at some numbers. The recent interim budget allocated about Rs. 46bn for social safety nets. The loss from one of the state-owned enterprise for 4 months was Rs. 200bn. State owned enterprises need to be reformed and this can be through privatization, consolidation and public private partnerships.

The Government is collecting taxes from all the citizens including the poorest people and this is being channelled to these institutions and to support about 2,000-3,000 employees in these institutions.

Top loss makers (2015-2020)

What does tomorrow hold for us?

Sri Lanka is now at a crossroad. If we make this an opportunity, and we embark on a journey to introduce the reforms that are required to come out of this crisis, then Sri Lanka can become a tiger economy in the future. However, if we do some reforms, and try to fix some problems, but we do not completely revamp our systems, then into the future, Sri Lanka may become a failed state. Therefore, in my view, there are 5 possible scenarios that I can envision for the future of our country;

1. Forming Reform Committees: Formation of Reform Committees and Sub Reform Committees but not implementing actual reforms
2. Introducing some reforms: Introduction of some reforms equals to no reforms as these are not complete reforms and will not be able to address the issues in the entire system.
3. Capitalizing on low expectation: The expectations of the people of our country are currently at a minimum. For example, people feel that 2-hours power cut is fine. We were used to 5-6 hours power cuts a day. Therefore, the politicians may try to channel most of the resources just to meet these low expectations and capitalize on their political needs. No actual reforms are done.
4. Making reforms an entry gate for corruption: Reform agenda may be taken over by the same people that lead corruption. Reforms need to have the element of transparency.
5. Implementing more and more reforms. Everyone moves to a state of mind that requires reform. We implement a reform package where all the necessary reforms are done step by step and fix all the problems. This is the best-case scenario.

In conclusion, Bruce Lee said that

> "*Knowing is not enough. We must apply.*
> *Willing is not enough. We must do"*

It is still not too late for Sri Lanka. If we do the reforms that are needed to be done now, we can become a tiger economy in the future. If not, Sri Lanka may become a failed state. All of us as citizens, and especially professionals need to have a reform mind set and urge the leadership to make the changes that are required to reset Sri Lanka.

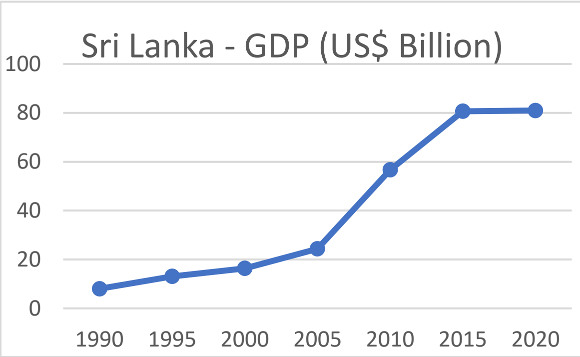
IMPROVING THE TAX SYSTEM IN SRI LANKA

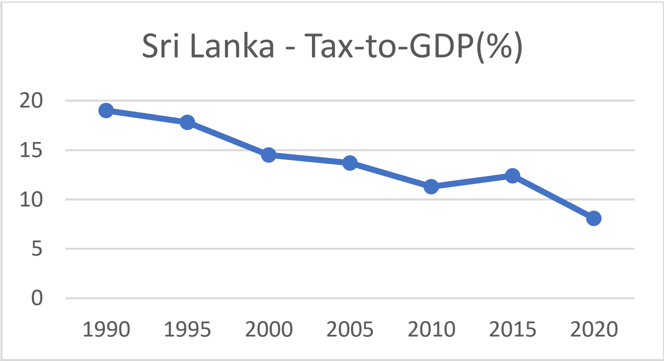
The third session of the annual Tax Symposium was on the global and local tax trends and the lessons Sri Lankan policymakers can learn from its regional and global peers. This article is on the analysis made by Dinusha Rajapakse, Associate Tax Director of BDO Partners in her presentation on the tax systems around the world and how Sri Lanka can improve its tax policy to be aligned with global trends.

1. **Tax as a revenue collection tool**

As the economy and population in various countries are different, "Tax to GDP" is a commonly used denominator to analyse the tax systems of the world. The tax to GDP ratio measures a country's tax revenue, relative to the size of its economy. A higher tax to GDP ratio means more money is going to the Government coffers, which in theory would mean better public services like education and infrastructure. It can also mean long term stability of the economy.

Based on a research conducted by the International Monetary Fund, countries should have a tax-to-GDP ratio of at least 12% in order to experience accelerated economic growth. In 1963, Niclolas Kaldor argued that for a country to become "developed" it needed to collect taxes at 25%-30% of GDP. The irony of the situation is that while overall GDP as well as per capita income of Sri Lanka has been steadily increasing over the years, government total revenue and tax revenue has been steadily decreasing.



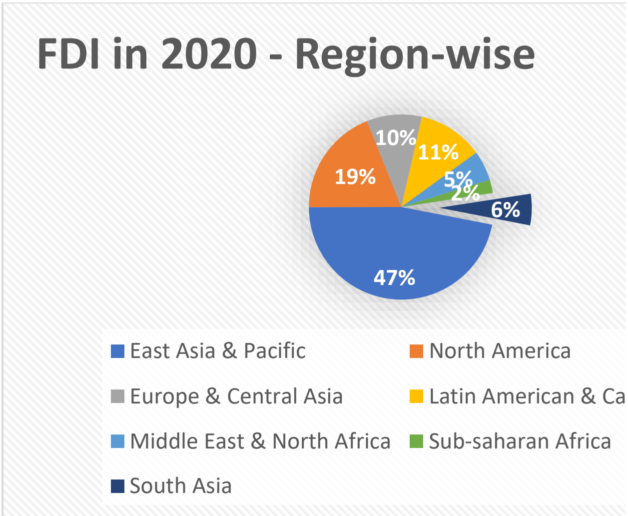


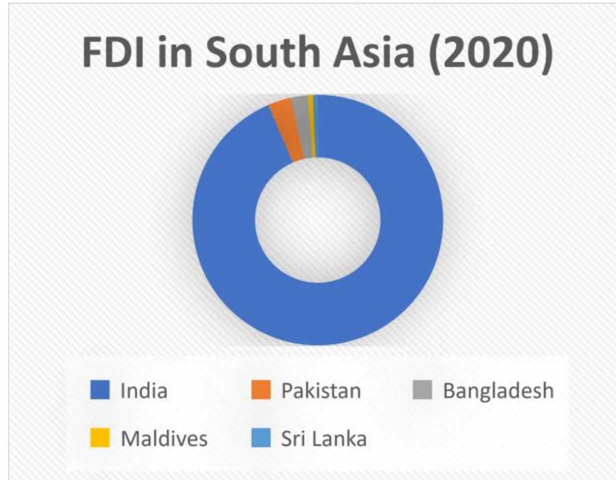
The fact that the country's revenue is not sufficient to even finance the maintenance expenditure of the government means that it is forced to have recourse to borrowings even for its day-to-day operations.

There are several reasons for this declining trend;

1. Unplanned ad hoc tax incentives in the form of various tax holidays, reliefs and concessions, duty waivers etc. which have eroded and narrowed the fiscal base.

The exact loss from these concessions for each year of assessment has not been calculated but has been estimated at being close to 1% of annual GDP as per the presidential taxation commission set up in 2010. A key proponent for tax incentives, especially in the form of tax holidays, is to attract FDIs into Sri Lanka. However, we need to ask ourselves how effective fiscal incentives are as an enticement tool? Looking at the past, attracting FDI has been challenging, despite years of favourable tax treatment offered to FDI by way of generous tax holidays, exemptions and concessionary tax rates. Sri Lanka attracts substantially less FDI than most of its middle-income peers with only USD 433 thousand in 2020 according to World Bank statistics.





Based on the statistics published by the World Bank for 2020, of the total FDIs only 6% was channeled to South Asia. Of this amount 93% has been channeled to India and Sri Lanka has only got 1% of the total FDI in South Asia.

Almost 47% of FDIs have been to East Asia and Pacific Region. We have a significant amount of competition coming from the Southeast Asian region for foreign investments. It is one of the fastest growing regions in the world. Intra-ASEAN trade and investments have been rising significantly in the past few years through the ASEAN Economic Community (AEC) Initiative. Through the AEC, the member-states of ASEAN seek to lower regional barriers to trade and harmonize rules and standards to further expand intra-ASEAN trade and investments.

Interestingly, the ASEAN has not begun examining the possibility of adopting a harmonized or integrated tax system. There are significant differences in the tax system in the member countries. However, we have Europe adopting the EU model and the Gulf adopting the "The Economic Agreement between the GCC States". While conceding to the fact that regional ties and mutual co-operation is essential between neighboring States, there is no one formula that fits all. As a nation we need to build bridges to ensure that we are at the best vantage point to attract opportunities.

Given the situation in our country, we need to attract FDIs into the country as a means of economic growth and to bring in more foreign currency into the country. However, all tax-incentives have one thing in common – they reduce the quantum of tax ultimately payable. On the other hand, the tax to GDP has deteriorated significantly and therefore, we have to also be conscious of the tax revenue that is being generated through operating these businesses in the country. Balancing these competing interests is a policy paradox that we need to navigate with utmost care.

Up-front tax incentives like tax holidays can help address cash flow problems that may inhibit investment, particularly in respect of startup projects. Investment tax credits provide immediate and full expensing of capital costs. On this basis, it can be argued than up-front incentive tied to new capital purchases should be preferred to statutory corporate tax rate reduction. In this way, incentives will be directly proportional to the amount of actual investment. However, one can argue that up-front incentives are inefficiently targeted in that they reward inputs rather than outputs. i.e., they subsidize the purchase of capital rather than the productive use of those inputs in generating outputs/profits.

Accelerated depreciation is a form of capital investment-based investment allowance which provides for the writing off the cost of an asset at a rate faster than the true economic rate of depreciation. While this treatment does not alter the total amount of capital cost to be depreciated, it increases the present value of the claims by shifting them forward, closer to the time of the investment. It is important to note that accelerated depreciation is a ‘timing benefit’. i.e. it only alters the timing of the tax payable and not the actual amount of tax. Therefore, the cost to the Government in providing this is less than that of tax holidays and investment allowances. It is the least costly incentive in terms of revenue forgone. The downside however is that it is a direct encouragement to capital-intensive industrialisation as opposed to labour or knowledge-intensive projects.

International experience and evidence suggest that tax holidays seem to have a more pronounced effect in attracting short-term investment that may well leave the host country or form a new company once the tax holiday expires, whereas other incentive types like investment allowances/tax credits and accelerated depreciation may be more effective in incentivizing longer-term investments.

2. Narrow tax base and coverage, the total number of taxpayers being about 1.33% of the population.

Based on the Annual performance report published by the Inland Revenue Department for the year 2021, the number of taxpayers has been published.

	as at 31.12.2021	
Income Tax		
Corporate		
Resident Companies / Non - Resident Companies/ Bodies of Persons	68,009	
Non - Corporate		
Individuals	292,305	
Partnerships	16,798	
Employees paying Income Tax under Advanced Personal Income Tax (APIT) Scheme	32,702	
Total Income Taxpayers		**409,814**
Other Taxpayers		
Persons registered for Value Added Tax (VAT)	9,070	
Persons registered for Value Added Tax on Financial Services	246	
Persons registered for Betting & Gamming Levy Taxpayers	660	
Total Other Taxpayers		**9,976**

According to these numbers of the 22 million population only 292,305 individuals are registered taxpayers. That's less than 2% of the entire population. Of the 68,009 companies that are registered for corporate income tax and 16,798 partnership business, only 9,316 are registered for VAT including VAT on financial services. That's about 10% of those doing business are in the VAT net. Therefore, we have a very narrow tax base in Sri Lanka with only a fraction coming within the formal tax net. Therefore, this needs to be addressed to increase the tax revenue to the Government in order to increase the tax-to-GDP ratio.

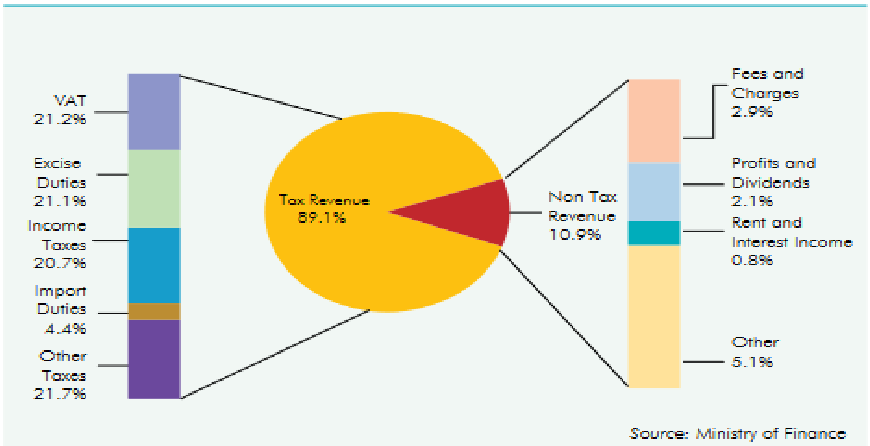
3. Composition of tax revenue – direct to indirect

Linked to the same issue is the composition of tax revenue – direct to indirect tax ratio. Direct taxes tend to be progressive and intimately related to the ability to pay and can be used for reducing income and wealth inequalities. However, it is more difficult to impose in developing countries with the existence of a large informal economy and higher unemployment rates. It is also a deterrent to saving and investment and therefore adversely impacts economic efficiency and improving of living standards.

Indirect taxes are imposed on the consumers of taxed commodities. The public is less conscious of the tax burden as the taxes are generally hidden in the prices and the presence is not readily felt by the consumer. It is also perhaps the only means of reaching the vast majority of the population whom the tax net often fails to capture and the informal and hard to tax activities. Administratively, indirect taxes are easier to implement than direct taxes and since they are included in the price of a commodity cannot be easily evaded, and the administrative costs in their collection is relatively low.

However, indirect taxes are heavily criticized for necessarily imposing heavy burdens on the lower- and middle-income groups and those least able to pay and therefore tend to be regressive. In developed countries, direct taxes such as income tax constitute a significant portion of total tax revenue. In contrast, in developing countries the opposite is the case with the bulk of government revenue coming from indirect taxes.

Figure 6.3
Composition of Government Revenue - 2021

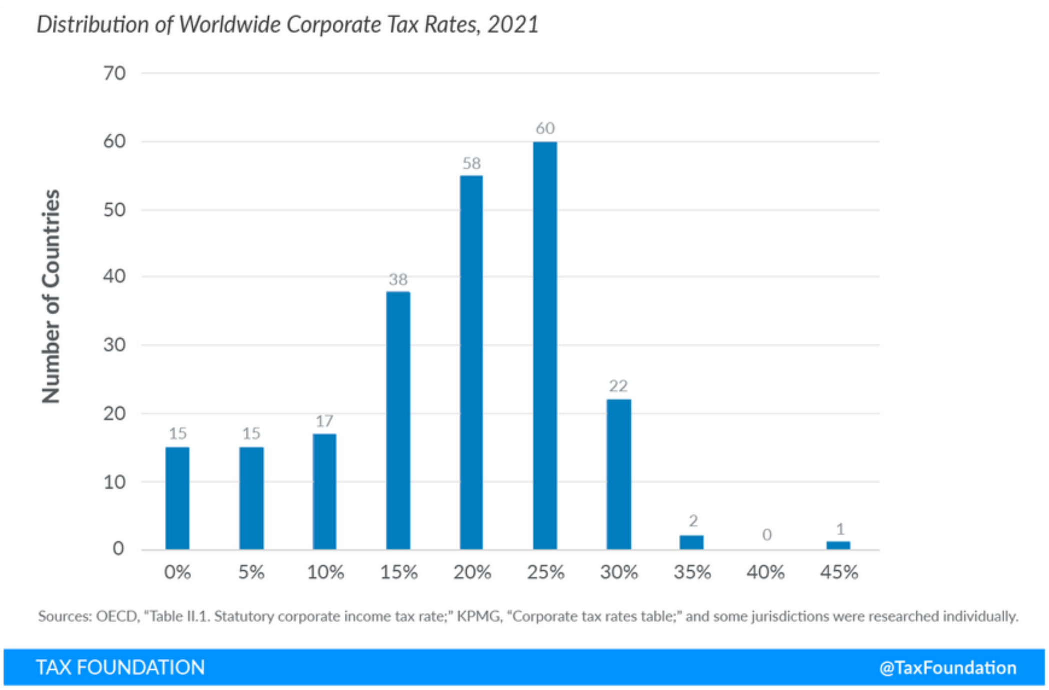


In Sri Lanka, based on the data for 2021 published by the Central Bank, about 20% of the tax revenue is from income tax while the balance 80% is from indirect taxes. It is understood that this proportion of direct to indirect tax is too unrealistic if Sri Lanka is to achieve a developed country status from a middle-income country status.

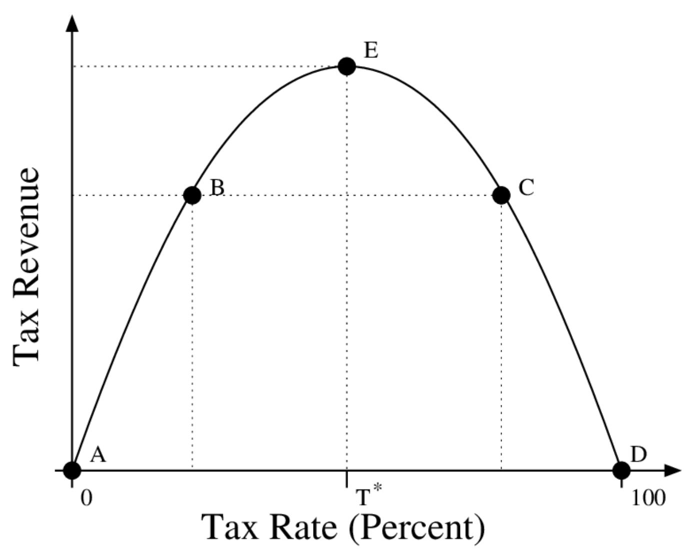
The then Prime Minister and now President Hon. Ranil Wickremasinghe in his Economic Policy Statement delivered in Parliament on 5th November 2015 even set a quantitative target of securing 40% of the tax revenue from income taxes by 2020. This requires policies to reduce the share of indirect taxes from the present average of 80% to 60% which means increasing the income tax by 100%.

4. Tax rates

Another issue that tax system has to grapple with is the tax rates imposed. Most countries have adopted corporate tax rates in the range of 20% to 25%.



Common sense would tell us that increasing the tax rate would increase tax revenue. However, if you look at the Laffer Curve, it indicates the effect of tax rates on government revenue.



Briefly, the proposition of the Laffer Curve as its starting point is the simple notion that tax revenue is zero if the tax rate is either 0% or 100%, with a smooth relationship between the rates and tax revenue connecting these two polar points. The existence of such a relationship suggests that there are always two rates available (B and C) which produce the same total tax revenue, one a higher and another at a lower rate. Government, therefore, need not necessarily choose a higher rate to achieve the required quantum of revenue.

5. Ad hoc changes to the tax system to meet short-term cash flow requirements of the government

In Sri Lanka, we see successive Governments removing certain tax, introducing new taxes, some permanent and someone off like the Surcharge Tax. Some taxes aimed at only certain industries like Tourism Development levy, betting and gaming levy, crop insurance levy etc. This creates complexity and poses severe challenges to the tax administration. It also acts as a deterrent to new investments.

In India, over the last few years, the Central and many State Governments have undertaken various policy reforms and process simplification towards great predictability, fairness and automation. This has led to India's rise to the top 100 in the World Bank's Ease of Doing Business (EoDB) ranking. India has jumped 79 positions from 142nd to 63rd ranking based on the stats published in 2020. The Goods & Services Tax (GST) reform is one such reform that has contributed to this achievement as it eased the complex multiple indirect tax regime in India. GST is a comprehensive indirect tax levied on manufacture, sale and consumption of goods as well as services at the national level. It has replaced all indirect taxes levied on goods and services by the Central and State Governments.

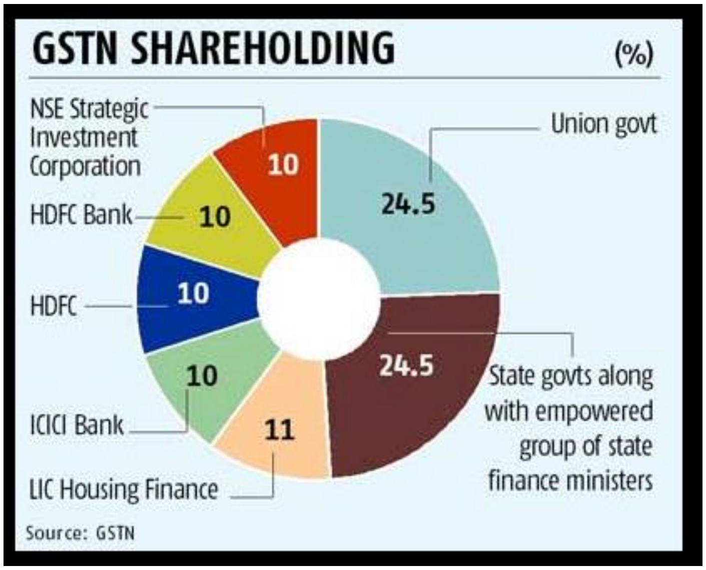
Sri Lanka too, needs to simplify its tax system and have a mechanism to adopt precise medium to long term tax policies.

6. Revenue Administration has not embraced technological developments

The Revenue Administration Management Information System (RAMIS) is the technological tool that is being used by the Revenue Administrator in Sri Lanka. With effect from the Year of Assessment 2020/21 it was mandatory for all corporate taxpayers to file their Income Tax Returns online. Filing of VAT returns are also facilitated through the system. With the pandemic, a payment gateway to make tax payments was introduced by the Inland Revenue Department. These are good improvements in introducing technology for revenue administration purposes. However, we also need to assess whether the RAMIS meets the requirements of all the stakeholders and does it in fact provide ease to both the taxpayer and tax administrator.

On the 16th of August 2022, DailyNews featured an article, "RAMIS deeply unfit for purpose" which is a statement made by Prof. Mick Moore a Political Economist, Professional Fellow at the Institute of Development Studies told the 'Reform Now' Conference. There is no IT cadre within IRD; and they depend on a range of odd people to try and fix their IT problems," Prof. Moore added. The Morning newspaper on 17th March 2021 published an article, "The Inland Revenue Trade Unions want RAMIS replaced". The article reports that the spokesperson for the Inland Revenue Trade Unions Joint Committee commenting that "as it is not flexible enough, and too complicated, the working hours of employees are wasted, because they are still not used to the system and its complexity. Another point is that, although there is a committee, there was no department consultant from the Inland Revenue Department (IRD) who managed the system. The only consultant was in Singapore". There are various challenges and issues being faced both by taxpayers and the administrators.

Technology, is always, a key driver of innovation, and is at the heart of enabling activities to evolve and maintain a commercial advantage. For example, in India, GST network (GSTN), is the software used for administering the GST and provides the computing resources for administering the tax and it was developed by Infosys Technologies. GSTN is a non-profit organisation formed to create a sophisticated network, accessible to stakeholders, government and taxpayers to access information from a single source (portal). The portal is accessible to the Tax authorities for tracking down every transaction, while taxpayers have the ability to connect for their tax returns.



The GSTN's authorised capital is ₹10 crore (US$1.3 million) in which initially the Central Government held 24.5 percent of shares while the state government held 24.5 percent. The remaining 51 percent were held by non-Government financial institutions. However, later it was made a wholly owned government company having equal shares of state and central government.

Sri Lanka too, can look at a public private partnership in relation to introducing technology for revenue administration.

2. **Transfer Pricing and BEPS**

The laws relating to transfer pricing have been in our statutes since 2006. However, transfer pricing was implemented in 2013, with TP regulations been published by gazette. The law and regulations are largely based on the OECD standards and has adopted the minimum standards. The most significant drawback in implementing TP in Sri Lanka is the lack of a database developed locally for this purpose. Most companies resort to Indian databases for benchmarking, which sometimes may not reflect the most comparable data, especially since it does not factor in the country risk.

Another challenge for taxpayers in Transfer Pricing is that even though the arm's length price referred to in section 76 and 77 may be subject to safe harbor rules specified by the Commissioner-General, no guideline has been issued yet on safe harbor rules. Many foreign entities wanting to set up operations in Sri Lanka are nervous about the margins expected to be retained in Sri Lanka, especially in the IT and service sectors. They are compelled to undertake expensive benchmarking exercises since the safe harbor rules are not published. Data on companies in the IT sector are also not available in the public domain as there are currently no listed IT companies in the Colombo Stock Exchange. Companies engaging in cross border transactions that are keen to pay their fair share of taxes in Sri Lanka will be willing to adjust their prices in line with the safe harbor regulations which in turn will increase tax revenue to the Government. Further, adopting these regulations will be administratively more cost efficient in tax collection than having to do TP audits and instituting recovery action.

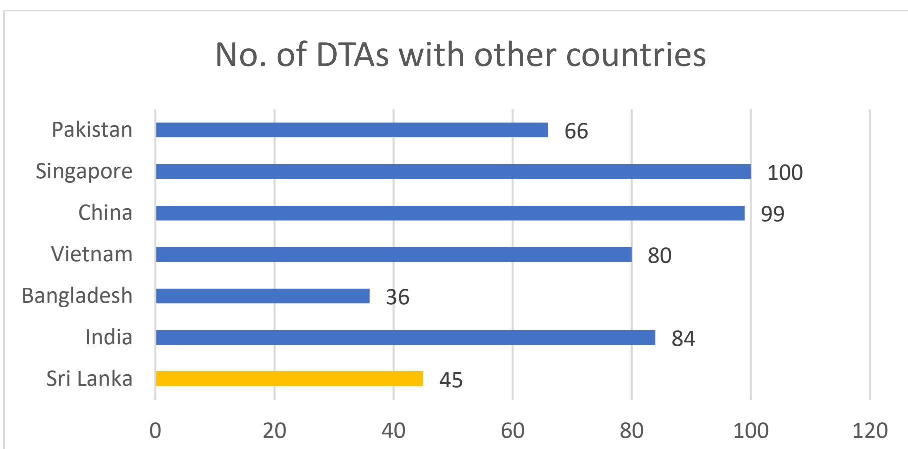
The TP regulations require Multinational Enterprises to submit Country by Country report (CbCR) to the Inland Revenue Department. However, since Sri Lanka has not entered into agreement with other countries for Automatic exchange of Information, such MNEs are required to file the CbCR in their jurisdiction of residence as well as Sri Lanka. This is a cumbersome process.

The OECD has released a Transfer Pricing country profile in June 2022. Based on this document there are certain aspects of Transfer Pricing that has not yet been implemented;

a. No specific Guidance on commodity transactions
b. Sri Lanka does not have specific guidance on pricing of controlled transactions involving intangibles.
c. Sri Lanka does not have specific guidance for intra-group services.
d. No simplified approach for low value-adding intra-group services
e. Sri Lanka does not have any specific guidance for financial transactions

3. International Taxation

Based on the information published by the Department of Inland Revenue, Sri Lanka has entered into 45 double tax agreements and 1 multi-lateral treaty.



Taking a look at other nations, the treaty network in Sri Lanka can be expanded further. Sri Lanka has DTAs with all the top 5 export and import countries. However, we only have limited DTAs with Honk Kong and Saudi Arabia. We do not have DTAs with New Zealand, South Africa, Turkey, Mexico and Brazil and most of the emerging markets as defined by the IMF. Brazil and

South Africa are both in the BRICS nations and we need to expand our treaty network to engage more with emerging economies.

In Sri Lanka in 2020, we saw a tax exemption being given to non-residents on dividend income and interest income. This would mean that any foreign investment to Sri Lanka as equity or debt will not attract any tax in Sri Lanka on the returns. However, we need to see how effective this exemption is. Sri Lanka has double tax treaties with 45 countries. Most investments to Sri Lanka come through the countries that we have double tax treaties with. Therefore, even if the non-resident person was to pay tax in Sri Lanka, such investor is entitled to a tax credit for the tax paid in Sri Lanka under the double tax treaty. Even though Sri Lanka exempts this income in Sri Lanka, such non- resident person may still be liable to pay tax in his country of residence. Therefore, tax exemptions on return on investments may be counter-productive and only result in Sri Lanka losing its fair share of tax revenue.

Currently there is an exemption on interest paid to a non-resident lender. Therefore, investors will channel funds to local businesses by way of loans rather than equity. The return on a loan which is the interest is charged as an expense to the profit and loss account which is considered as a deduction when computing the profit before tax. However, dividend which is the return on equity is distributed on the after-tax profit. Therefore, there is a tendency for non-resident investors to charge higher interest rates to reduce the profits which are liable to income tax in Sri Lanka. Therefore, tax adjustments like the earning stripping rule should be introduced where the deductible interest expenses payable to a foreign lender is limited to a certain percentage of the profit before tax.

If Sri Lanka is to use taxation as an effective revenue generating tool, it is imperative that we re-look at the tax systemin Sri Lanka and make it more aligned with the policy objectives of the Government. “What the Government gives, it must first take away”

WAY FORWARD 2023 AND BEYOND – *CHAMBERS DISCUSSION FORUM*

Several leading business associations and chambers were invited to the fourth session of the Annual Tax Symposium 2022 to share their views and opinions on the present tax regime in the country and the changes that they would like to see in taxation policies in future. This article provides a concise note on the deliberations of the delegates from the chambers and business associations namely Ceylon Chamber of Commerce, National Chamber of Commerce, Chamber of Young Lankan Entrepreneurs, Sri Lanka Chamber of Small and Medium Industries and Women's Chamber of Industry and Commerce.

*(**Note:** Views expressed by the panelists are their personal views or the views of their respective chambers/bodies/associations that they represent.)*

1. How important is taxation in attracting FDIs?

"There are two schools of thought that are currently being discussed. One is that foreign investors do not rank taxation as a priority when making investment decisions. This position could be accepted if you take all indices, and they remain strong for Sri Lanka. Investors will first look at market access, labor laws etc. before taxation. But unfortunately for Sri Lanka, the other indices at the moment are not in our favor. The social indexes and laws are not in our favor. Therefore, taxation which may be number 6 under the best of situations could be the number 1 position for us to attract FDIs. Therefore, foreign investors who are coming here may have to be given some incentive to look at Sri Lanka favorably, especially in the current situation where there is an issue regarding capital repatriation and dividend repatriation. Having said that, the delegate is also not in favor of extending the existing concessions and calibrating the tax system. At some point of time, we have to get out of giving exemptions. Otherwise, we will never be able to broaden the tax base in order to increase our collection. Therefore, it is very difficult to say what is the best at this moment. We have so many complex situations that we are facing. A-on the exchange side and B-on the investment side and more than anything else, on the revenue side."

2. Are you proposing relief?

"Actually, tax reliefs should not be encouraged. Even the existing tax exemptions should be removed both in the income tax and VAT law as much as possible. It has been mentioned that the income tax has to be increased and not VAT. But it is not possible to increase income tax as the tax base is much smaller than the VAT base. You cannot increase income tax beyond 28% - 30% rate. Under the law of diminishing returns, there is a low income that you get after 30%, 40%, because there is no investment that will take place. VAT is the only tax that has a wider base. So, unless we go for increasing the base of the VAT, we are never going to increase our revenue to the level the country is expecting. But if there are the vulnerable sectors in the society who are affected as a result of increased taxes, then the government needs to look after them in the form of subsidies. The government can target those people and give a grant but should not use the tax system to give relief. The tax system should be only for revenue collection."

3. **How important is policy consistency in terms of taxation?**

"Not only in tax, even in the other areas there are policy inconsistencies. For example, when somebody is going to invest or maybe start up business or maybe making investments in whatever they do, they need to plan for a 5- 10 years horizon. When you plan in a 5 -10 year horizon and suddenly something unexpected happens, especially something relating to taxation, it has a serious impact. Sometimes it is possible for us to predict certain macroeconomic issues like interest rates, inflation, supply chain issues. Unfortunately, from time-to-time ad hoc tax changes is something nobody can predict. That has been one of the serious issues as we understand. Sometimes what happens is people invest in certain areas and then finally the investment would not be viable due to unexpected policy changes coming from the tax domain."

4. **As Young entrepreneurs how do you see the current situation?**

"It is always debatable, on whether a country should import and supply to the market at the best price should be followed as a policy or whether we get the local industries to make sure that they come out with quality products. Even if we do not follow a policy where 100% is produced in Sri Lanka, at least the majority should be produced in Sri Lanka. That will help the economy in the long run. There are some areas that we continue to pursue, and agriculture is one of the areas we have concentrated on. We need to see whether we can modernize the agriculture sector, because it is still very traditionally done. We have not infused technology into agriculture. If we take 20 years ago our exposure to technology and how we use technology could be understood from the size of the mobile phone. Just imagine another 20 years from now, where things will be. For youngsters it is all about APPS, software and concepts. Therefore, we need to invest and focus on our next generation. Their education system has to change. Unfortunately, we are all focused on just studying and getting through exams, writing down what we studied, getting marks and getting qualified. But that's not the way forward. We have to focus on our innovations. As a nation, we should try to change the way that we do things, look at innovations, get young kids' ideas and support and give them a free mindset to innovate new things. To enable that we need new tax policies. Companies need to put out innovation centers, and data centers so that the youngsters can just plug in and start being creative."

5. **Where do we stand in terms of SMEs?**

"The SMEs contribute a significantly to the GDP. It also cuts across all sectors including agriculture. In the past decade immediately after the cessation of the war, SMEs have remained impoverished. They have been highly geared. SMEs faced the pandemic in that backdrop. Coming out of the pandemic, it would not be easy for SMEs. The moratoriums have helped them, but it is not clear on whether they are ready to face the economic crisis. The biggest threat that SMEs are facing is their own survival. Some of them may have to close down their businesses. The chambers are playing a role and trying to hand hold these businesses with the support of the relevant institutions. They may need some kind of safety net to be able to survive during the crisis, especially in the next two or three years. Talking of innovation and infusing new technology and bringing them into the future is something we can work collaboratively, maybe with the other chambers as well as the institutions that are working in those sectors. Even international bodies like UN or even multinational financial institutions like ADB can support SMEs to work in this direction. Earlier it was entrepreneurs in family-owned businesses or individual proprietors who started new businesses. However, their children are no longer interested in continuing these ventures. Therefore, we need to look at that as well. These businesses support industries, including export, tourism, leisure hotels, transport, construction etc. If we are to sustain this sector, then definitely we need to bring new technology and help the next generation take it on. Therefore, it is a collaborative effort.

6. **How equipped are SMEs in terms of their knowledge of paying taxes?**

"SMEs could be classified into two categories in this regard. There are some SMEs that are knowledgeable and may be even taking advantage of the tax laws. The other segment is ignorant about management skills, financial management, and corporate governance. This is where the chambers, together with banks and other institutions try to educate and help them. We are taking it down to the provinces and meeting our regional chambers to assist such people to understand. So, maybe the tax authorities also need to create awareness of SMEs. If they are contributing to over 60% of the GDP, then that is a very big part of the tax network. We need to take it educate them of their responsibility in paying taxes. In most cases, micro industries are not sophisticated to avoid taxes. However, they have to have an understanding of why they should pay taxes. So, it is up to the tax authorities to make it clear to them as to why and how they should pay taxes.

7. **Your thoughts on micro industries and women empowerment…**

"To quote a few statistics to show the importance of SMEs…. 91.8% of the total entities in Sri Lanka are micro entities, 7% classified as small, 1% as medium and 0.2 as large (based on 2013/14 statistics). If you take 45 % of the entities into the tax net and even if you introduce a very simple method of taxation, you are automatically looking at a big jump in tax revenue immediately. The statistics show that this is a significant segment that contributes largely to the economy, but it is also a segment that nobody pays attention to. In 2016, a very good white paper was done by the Ministry of Industries National Policy Framework for SME development. It highlighted a lot of issues that SMEs had, after a lot of research. Six years down the line it is still a document. Nobody has picked it up, nobody has implemented it. If at least a few of the basic proposals like making the registration process easier for SMEs was implemented, most of them would have been in the formal sector now. Also, we do not have a database of the entrepreneurs in Sri Lanka. We do not have a national database. Therefore, how are we really going to evaluate their contribution? How are we really going to assess what they are going to do? One of the biggest problems we have seen is that women do not have proper access to get into the formal sector because the ways in which you can be a formal entity in Sri Lanka is either to be a sole proprietor, partnership or a limited liability company. As a female you would not want to hold a sole proprietorship and partnership because the risk is high. Then they would want to set up a limited liability company and the requirements are too high. So, all these women do cottage businesses. What we have to do in order to help them is, simplify our registration and have a separate law for SMEs.

8. **Having a tax file for all citizens is a good idea?**

"If the idea is for revenue enhancement, opening tax files alone is not going to enhance revenue. The idea should be to bring people who do not pay income tax into the system. The Government could look at the big ticket items a person who has high income consumes. A – He might buy a vehicle B – He might buy a house or an apartment and these are the big-ticket items that a person who is earning high income is likely to spend on. So currently both the RMV, and the land registrar of the relevant provincial councils send information of all the purchases to the Inland Revenue Department on a regular basis. Then the Inland Revenue Department first checks whether the particular person has an income tax file. If there is no file, the Inland Revenue Department sends the 1V form and if there is a file, they refer to the file. So, it becomes very easy for the revenue officer who is in charge of the file to ask questions like, "you have purchased a vehicle/apartment of this amount, but your income tax does not support it. Please explain how you got it?' If they follow this mechanism diligently and honestly, in my view, they can bring all these people who are not paying income taxes in to the tax net. Opening another 5 million files is going to be an administrative burden as the department is already finding it difficult to handle the existing files unless everything is automated. The government was trying to use ICT and automate to link the Department of Inland Revenue with the RMV and the Registrar General of Lands. But it did not take place. If that happens, then all these could have been corrected. Otherwise opening tax files is not going to enhance tax revenue. But of course, there can be some form of compulsion in that a person will think before transacting. Still, it is an independent system that is running on its own. So, in my view, I don't think opening a file will resolve the problem itself."

9. **What are the complexities you see in the tax system?**

In 1965, when Mr. D.B. Wanninayake delivered the budget speech (as the finance minister), he said that "I am making the tax system simple". In 1977, when Mr. Ronny De Mel took over the finance ministry there were about 18 changes to the legislation. He also said, 'I'm simplifying the tax system". Thereafter, in 2018 when Mr. Mahinda Rajapaksa presented the budget, he also said the same thing. The tax system is anyway a complicated system worldwide. It is a misconception to say that taxation is not complicated. As transactions are getting complicated, taxation is also getting complicated. Even the number of financial instruments that you have today is different from what you had 50 years ago. India is more complex than ours. The UK being a developed country, is more complex than ours. So, it is a myth in my view to say that taxation should be simplified and not complex. However, it is important to understand the affordability to pay taxes, concentrating on the different taxes we have. We have to drill down to find out who can pay taxes and who cannot pay. That is why we have a plethora of taxes to track each segment of society. Since we do not have a very rich society you cannot tax them more than what they are paying. We have to go in search of new revenue. In my view, the tax system will remain complex even within the next 10 years.

10. We had a couple of COVID-19 related tax concessions. Were they useful?

"Easter Attack in 2019 and then COVID led us into serious problems. After these issues hit us, there were a lot of concessions and a lot of other things which came into the picture including the moratorium. And then the economic crisis. So, it is a long time from 2019 to 2022 now. We need to look at it in that particular context. When the moratorium was introduced $1/3^{rd}$ of the banks' books went into moratorium and then they came out of it. After a while, it came down to maybe about 20% of the books. Some of these issues were caused by the mismanagement of the entire policy framework as well as the economy. Some of these are not going to work as expected. On the other hand, the poverty level has increased, and child malnutrition has become a serious issue. We cannot rely on the government because unfortunately, the government is also in deep trouble. So maybe over a period of time, we might not have consistency in taxation, because for consistent taxation you need to have a consistent economy and consistent policies. What we are trying to do now is a very restrictive kind of trade policy and protect local entrepreneurs. But when you have this kind of restricted economy, corruption becomes worse and the government becomes the largest entrepreneur. Then what happens is that private goods become insufficient. If you try to develop as a country without opening up your trade, then the country should be large enough to sustain itself. It is mathematically proven that, if you want to be self-sufficient, the population should be more than at least 300 million. So, we need to look beyond these restrictions. We need to go beyond things which allow the bureaucracy and politicians to manipulate the system. In my view, there are so many things that are connected to tax and to improve your tax base you need to develop the economy. You need to have the kind of thinking and planning which is far beyond our framework.

11. How difficult is it for entrepreneurs to deal with corruption?

"Corruption starts when you have too much red tape. When the process of getting things done becomes very long, corruption starts. We need to simplify the ways in which we are doing things. Especially in terms of business support services. Even for investors coming to Sri Lanka, we have always been talking about one-stop shop concept for years, but it has never been implemented successfully. Investors are sent from pillar to post. If the investor has a good local partner or good consultant, they will explain the way of getting things done and if they are patient they will wait. If not, they will walk out. There are other countries in the region that are also waiting for FDIs and for investors with open arms. If we focus on technology and automate everything, then we can reduce corruption.

12. **Do you have any suggestions on how we can improve tax technology in terms of collection and administration?**

"We are far behind in terms of technology. Technology needs to be introduced to revenue collection. Authorities have to be linked with other bodies such as RMV, the registrar of companies etc. Then the tracking is much easier. The problem is with the revenue administration and the human resource skills. The capability of Inland Revenue Department has deteriorated from what it was and what it ought to be. We cannot expect much improvement in the revenue collection even if we introduce technology unless the department improves its human resource skills in terms of application as to how they do audits, how they select for audits and how corruption can be eliminated. These are the things that they really need to concentrate. Corruption can be eliminated if there is more technology and more transparency in the record-keeping process. However, still collusion can happen. Corruption at the revenue collection authority does not take place with one hand. Both the taxpayer and the officer are involved if there is corruption. And we as tax consultants and Chartered Accountants must advocate, a practice that is corruption free."

13. **How can we get more women into our labor force so that they contribute to the economy and in turn to tax revenue?**

"60% of the university education which is free is used by women. When it comes to giving back to the economy it is only 33% of that is in the formal labor force and out of that 33%, majority are low-skilled women. Most of the high skilled women subsequently get out of the formal labor force. The reason for this is their family obligations, like childcare, and elderly care. The responsibility of the family is on the women. The lack of flexible working arrangements in Sri Lanka is another issue. Recently John Keels Holdings came up with a fantastic idea where they give maternity leave to both men and women. Hope a lot more companies will follow that. That helps to decide on who is the most skilled person between the husband and wife. Sometimes we find the woman is the more skilled, and who can contribute more to the economy but has stayed back because of household responsibilities. We have even proposed tax policies to look at the maternity benefits. In the government sector there is no problem, they pay the maternity benefits. But other companies are reluctant to carry this cost of a woman for six months without getting any benefit. Even IMF is proposing expenditure-based tax concessions. So why not allow companies that are giving maternity benefits to deduct such costs.

Not only women, even companies that hire differently-abled people, should be given additional tax concessions to encourage them. We have brought proposals to the domestic help sector. It should be formalized and should not be done as a favor. In some countries they are highly skilled, and nobody minds leaving a child with a maid like that. We need to bring our maids to that category. Then you will be able to pay your maid more because you are doing a job with a higher salary. In that way, you also contribute to the economy. The government has to facilitate these women by spending money and educating them."

14. What would you like to see in the budget 2023? The final remarks of the panelists.

“We have addressed most of the short-term issues at the moment pressuring us and we need to look beyond that. We should capitalize on our geographical position globally. The budget should look beyond and play a part in some of the issues that we brought up today. Like innovation, giving opportunities to young entrepreneurs and women entrepreneurs in order to contribute to the economy in the next 5 to 10 years. A clear policy and a simple tax system might be the best way forward.”

“2023 budget is not going to be a wishful budget. The bad news is yet to come in my view. In order to overcome the current crisis, I think the budget has to concentrate on deficit reduction. The deficit reduction has to come from A. increasing revenue B. Public sector reform. This won’t be easy. It will be a slow restrictive process where the Government has to survive first. Since we are now in a stabilization position, we need to emphasize on public sector reform. We have to take the country towards a growth strategy at some point. Therefore, the 2023 budget can be a catalyst to do that change.”

“The expectation is for the country to have a positive primary balance. This particular issue of having a negative primary balance adds a huge amount of debt which is maybe running into 120% -130% of the GDP at the moment. 2023 might be the starting point and we need some certainty, over a period of at least 5 years. In order to make this a success, there should be an independent budgetary committee with some amount of consultation and voice. If you have a strong framework, deviations should go with public consultation. In brief 2023 budget should not be another budget, it should be something linked to the overall economy and maybe linked to a 5-year horizon policy framework.”

“The main focus of the 2023 budget should be on how the Government is going to increase the revenue. One of the things that the budget must look at is how it is going to help businesses grow their income. And also, when a decision is being made it should be logical. For example, now we do not have foreign currency to import some of the essential items and 300 items were banned. Nobody assesses the impact that this is going to have on the businesses. For some of those imports, we do not have enough supply in Sri Lanka for substitutes. Therefore, companies engaged in that business are going to shut down. That is another loss of another potential taxpayer. It cannot only be increasing taxes, it also has to be increasing the revenue (income to pay the taxes)”.

“We have now hit a reset to the country. We are at an ideal juncture where we can look at a new direction especially with regard to the youth. The youth going through university education, when they pass out, a majority are unemployable. We need to look at reskilling them. When they are frustrated without jobs various issues come up. If they are duly engaged, they will contribute productively to the economy. As soon as they pass out, they need to be occupied. The budget should allocate or at least should set a path to reskill in order to make them employable. Then in return, we can run our businesses more profitably and the government can tax more and get more revenue.

BASE EROSION AND PROFIT SHIFTING (‘BEPS 2.0’): AN OVERVIEW

Senali Udugama
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Background

The Organization for Economic Co-operation and Development (‘OECD’) initiated the Base Erosion and Profit Shifting (BEPS) project in 2013 to address the tax challenges arising from, shifting of profits from higher tax jurisdictions to lower-tax jurisdictions or tax havens which thereby affects the tax revenue of the country generating the income hence, eroding the tax base of the respective jurisdiction.

It was the intention of both OECD and the G20 to mitigate such aggressive tax planning strategies for the betterment of countries which were losing millions on tax revenue. As a result, fifteen (15) action plans were developed by way of recommendations, to overcome the adverse market conditions. The action plans addressed the following key areas, recommendation on tax challenges arising from digitalization of economy, recommendations to domestic rules to restrict interest deductions and other financial payments to limit base erosion, recommendations to prevent treaty abuse in inappropriate circumstances, stipulating mandatory disclosure rules to identify potential aggressive or abusive tax planning schemes, guidance on transfer pricing documentation and Country-by-Country reporting to enhance transparency for tax authorities while taking into account the compliance costs for businesses in maintaining such documentation, and recommendations for transfer pricing regulations (amongst others).

Ensuing recommendations of the 15 actions plans, the OECD identified that the tax revenue in certain jurisdictions were declining because the revenue generated from the supply of goods and services in such jurisdictions by most Multinational Entities (‘MNEs’), not having been captured under the prevailing tax laws.

Hence, it was evident that there was a lacuna in the tax law which provided an opportunity to most MNEs to circumvent tax liabilities in operating jurisdictions due to there being no physical presence in said jurisdictions, as a result of the varied business models adopted by such MNEs’ to suit the needs of today’s digitalized and globalized economy.

Interim measures which were adopted by countries

To address the issues in the tax regime in respect of the taxation of digital services, a new tax known as the ‘Digital Services Tax’ (‘DST’) was introduced by most jurisdictions.

DST is an indirect tax on gross revenue and as such since, it is not an income tax there are no tax credits available for those who are subject to DST.

Further it is to be noted that the scope and applicability of DST vary from country to country, depending on the thresholds and the types of activities covered for DST. Most jurisdictions, however, take into account activities such as, online advertising services, data transfer services, provision of services through a digital marketplace, functions carried out by app stores, cloud computing, use of digital currency and payment platforms and services are a few amongst the exhaustive list of activities.

What is BEPS 2.0?

In June 2021, G7 announced their support for OECD's proposals to address the tax challenges arising from digitalisation and globalisation. The proposals were structured around two-pillars which consequently paved the way BEPS 2.0 two-pillar solution -

1) Pillar one: A new nexus and profit allocation rules with the objective of assigning a greater share of taxing rights over global business income to market conditions, and
2) Pillar two: New GloBE rules to introduce a minimum tax of at least 15%.

Pillar One

Current tax legislation is such that a physical presence is required in the country in which goods and services are provided and tax is paid on the net profit derived from such operations. The Pillar One approach provides for profit allocation irrespective of a physical presence wherein the sales revenue attributable to each jurisdiction would be individually considered for tax purposes.

Pillar One would be applicable to Multinational entities (MNEs) with a global turnover above Euro 20 billion and profitability above 10%. If the MNEs have a profitability above 10%, a 25% should be carved out and re-allocated to market jurisdictions with nexus using a revenue-based allocation. As such Pillar One effectively requires MNEs to pay at least some tax in the markets they interact with.

It should be further noted a party signing up for Pillar One should withdraw from applying DST.

Pillar Two

This is an optional pillar and the main principle behind this approach is ensuring that profits are subject to at least a 15% global minimum tax. Hence, would be applicable for MNEs with global turnover of EUR 750 Mn. As such if the threshold is met the effective tax rate of at least 15% should be borne even at the subsidiary levels if not the ultimate parent entity would need to top up the tax rate to meet the difference between the minimum rate and effective tax rate.

The GloBe rules introduced through Pillar Two consists of Income Inclusion Rule ('IIR') and Under Taxed Payments Rule ('UTPR'). Article 2 of the Model Rules which stipulates the charging provisions provides for the definitions of IIR and UTPR.

Any jurisdiction can opt to impose Income Inclusion Rule ('IIR') on headquartered MNEs regardless of the threshold stated above.

In situations where the IIR is unable to be applied, the UTPR would be applicable, in which case if an entity has an effective tax rate lower than 15%, then all related party transactions are considered, and such jurisdictions could deny a deduction or impose higher withholding taxes if the necessary top up taxes are not paid by the entity with the lower effective tax rate.

The Pillar Two also includes a Subject to Tax Rule (STTR), which is to be implemented through bilateral tax treaties. STTR mainly focuses on intragroup payments between cross-border structures which avail treaty provisions to shift profits from source countries to jurisdictions in which tax rates are low or nil and especially in respect of developing countries which lack administrative capacities in identifying such transactions. STTR, provides an opportunity to source countries to protect their tax base by restoring taxing rights in situations where it is evident that the counter party jurisdiction has lower tax rates. As such the source country would be able to request for the withholding tax in the source country to be higher than the rate provided for in the treaty between the respective countries in respect of certain identified payments such as interest, royalties etc.

Around 137 member jurisdictions of the OECD/G20 Inclusive Framework are in agreement for BEPS 2.0 to be introduced in their respective states. Sri Lanka, however, is not a party in support of the introduction of BEPS 2.0. It is to be noted that changes should be made to the domestic legislation or bilateral treaties of the member jurisdictions by December 31, 2022 for the rules to come into effect as of January 1, 2023, with the exception of the UTPR, for which the application would be deferred to January 1, 2024.

Recent developments

Most countries our undergoing severe economic challenges in the aftermath of Covid -19 pandemic and the situation is further aggravated in the western region due to the sanctions imposed against Russia which has contributed to soaring energy crisis.

By way of letter dated September 09,2022, a joint statement was issued by France, Germany, Italy, Netherlands and Spain reaffirming the willingness to implement the global minimum effective corporate taxation in 2023 and to work together to sign a multilateral convention by mid-2023 for the better reallocation of taxing rights from multinationals' profits. The emphasis for the implementation of the global minimum effective taxation was reiterated by the said countries as a result of the heavy inflation which has a direct impact on the spending power of the citizens and hence, the companies are to pay their fair share of the burden to alleviate the impact of the global energy crisis.

Why BEPS is important to Sri Lanka

Sri Lanka is undergoing unprecedented times due to the detrimental impact which was left after the easter bombings followed by the Covid-19 pandemic which directly impacted the tourism industry, and the situation was further exacerbated by the tax cuts introduced a couple of years back. Each of these circumstances affected the government revenue and the foreign currency reserves of the country driving the Sri Lankan economy to an all time low.

Resilience is something all Sri Lankans have mastered throughout the three-decade war and the Covid-19 pandemic was another era in which all Lankans had to adopt to a new normal in order to survive the deadly calamity. Hence, such circumstances influenced many individuals to rely on electronic platforms to perform tasks ranging from work to purchasing essential items. As a result, there was a sudden spike in the number of sales through online platforms in both the domestic and overseas markets.

Further, the fact that most overseas suppliers do not have a physical presence in Sri Lanka created a competitive advantage for such suppliers against the domestic suppliers, since the overseas sellers had the opportunity of selling products at a relatively better price compared to the domestic sellers who had to bear in the tax costs and sell with an added value added tax on the sales price. Therefore, an unleveled market for overseas suppliers was created in Sri Lanka.

Even though, most countries in the ASEAN region had implemented DST or similar taxes to account for the income made by the non-resident / overseas suppliers, Sri Lanka to date has not enforced such taxation mechanisms.

Currently, there is a decline in the number of imported items due to the prevalent import ban on several products. However, if the import ban was not in place the country would be swamped with imported products especially through non-resident/ overseas suppliers which affect the livelihood of many domestic suppliers.

Therefore, it is evident that Sri Lanka too should consider introducing new tax regimes to meet the requirements of the future where globalization and digitalization would play a key role in each aspect of the society, hence, Sri Lanka should deviate from its path in depending on traditional tax revenues.

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MANAGING TAX COMPLIANCE IN A POST-COVID ENVIRONMENT

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Introduction

The article attempts to discuss the application of the findings of the paper published by Dissanayake and Kirchler (2021), titled *Perceived Effectiveness of Current Tax Compliance after the COVID-19 Pandemic*. The authors conducted a qualitative and descriptive study to explore the perceived effectiveness of current tax compliance strategies in Sri Lanka and derive considerations to improve them for the time after the pandemic. The in-depth interviews with entrepreneurs of medium-sized enterprises and tax experts such as a tax officer, tax policymaker, academician, tax auditor, and accountant contributed to collecting data for the study. The findings indicate that the current tax compliance strategies should be improved focusing on below areas.

i. Grant a grace period for tax payments and return submissions
ii. Understand taxpayers' current situation and benevolence
iii. Develop trust-building relations with taxpayers by treating them equally
iv. Invest in online services

The unprecedented government expenses and the declining revenue collection due to the COVID outbreak ballooned the budget deficit. The pandemic reduced levels of business activity in the manufacturing, construction, and service sectors and disintegrated the existing tax base. Since the government has been forced to produce extra support for the economy the need for revenue authority to help the country became crucial. However, an efficient tax system will support the government to finance its public expenditure. The authors influence the policymakers and the tax administrators to understand the shape of the tax compliance behaviour in a post-COVID -19 environment and revise the current compliance approaches accordingly.

Tax Compliance Practices after Pandemic

COVID-19 drove entrepreneurs to re-arrange their business directions and demand for labour. Hence, their tax-related responsibilities got less attention among other business priorities. On the other hand, the public expenses and unexpected health and welfare expenses resulted in high debts which signaled that the tax authority must earn more tax revenue. Therefore, the next "normal" will require considerable restructuring at the policy level in terms of economic and social reforms. Sri Lanka recorded a high budget deficit during the pandemic. The highest drop in real GDP by 16.3 percent in 2020 indicates that government needs more support to increase revenue (CBSL, 2020). The World Bank (2021) and the IMF (2021) highlighted the rapid economic decline in Sri Lanka and suggested that the policymakers reform tax compliance strategies immediately. Small and medium-sized entrepreneurs were identified as one of the most vulnerable groups during the COVID storm (Dissanayake & Premarathna, 2020). Therefore, it is time for policymakers to think of different compliance approaches considering medium-sized enterprises' issues and challenges due to the crisis. As suggested by the authors, before moving to revise tax compliance approaches, different compliance behaviours of individuals should be studied.

Why do entrepreneurs pay tax? The simple answer would be that they are forced by the tax authority to comply with tax regulations. On the contrary, one could say that there are those who think that paying taxes is an obligation and comply voluntarily with the tax system. Tax compliance is twofold because people who adhere to their tax obligations dwell between deterrence actions and psychological factors. So, tax compliance exists as enforced and voluntary compliance (Dissanayake & Kirchler, 2021). In Sri Lanka, we meet not only enforced compliance but also voluntary taxpayers. The work of the tax regime aims to find ways to bring non-complying taxpayers into the system while ensuring the correct tax is declared and paid on time by the taxpayers who comply. Tax compliance could be measured by the number of registrations in the system; timely filing cases; the number of cases reporting complete and accurate information (OECD, 2020); and the cases of on-time payment. If a taxpayer fails to meet any of the above obligations then they may be considered to be non-compliant.

Enforced compliance is challenging during a pandemic crisis as entrepreneurs find difficulties in continuing business with sudden curfew and lockdown situations that mainly affect the business income. Tax administrators should facilitate entrepreneurs by providing more service-oriented activities such as online registration, payment, and filing, rather than pressurizing individuals to pay taxes. Tax officials should understand the psychological condition of the business community while building trust relationships to motivate them to pay taxes voluntarily. The authors aim to understand the difficulties of taxpayers in meeting their tax obligations and derive suggestions to reshape the current tax strategies to increase compliance, particularly for medium-sized enterprises.

The authors assumed that the present tax compliance methods are insufficient for the new normal and therefore, the tax strategies should be revised for the post-COVID period. Analyzing the effectiveness of current tax compliance strategies, and interviewing taxpayers who own medium enterprises that are in the Colombo district the researchers attempted to explore the issues. As mentioned in the paper all the participants are registered with the Inland Revenue Department and represent different business fields such as service, construction, trade, and manufacturing. Besides, the researchers decided to collect more data to make the study more feasible, therefore, professionals from the tax field such as tax officers, tax policymakers, academicians, tax auditors, and accountants were also interviewed.

Registration Compliance

The study noticed that forced registration during a pandemic would create a hostile environment. Therefore, developing voluntary enrollment culture, the trustworthiness of tax administrators, and taxpayers' consciousness are required. In addition, the authors confirmed, that less faith in taxpayers about the government and the tax system, poor taxpayer-friendly environment, lack of knowledge among entrepreneurs, lack of awareness, and insufficient infrastructure facilities as challenges to developing voluntary compliance in the current system. As most medium-sized businesses were severely affected by the crisis, the business owners push to diversify their business and find solutions for their survival in the market.

However, it is revealed that people need considerable time to set up new ventures while planning to settle the dues related to the existing business. Government and tax administrators should wisely use this opportunity to assist and simplify the requirements of entrepreneurs and through that try to build individual's faith in the tax procedures and willingness to comply with tax registration duties. The authors suggest that introducing more training programmes and online knowledge-sharing sessions while educating people about the tax law and the negative consequences of non-compliance will encourage voluntary tax registration.

Filing Compliance

Tax compliance in terms of filing tax returns depends on the knowledge and experience of the taxpayer (Saad, 2013). The lack of tax knowledge push entrepreneurs to hire tax experts such as accountants, auditors, and tax consultants to get involved and settle tax issues. The COVID-19 lockdown, rule of work from home, and travel restrictions curbed the opportunities for timely filing returns. The study highlighted that the available online tax system is not fit for taxpayers' demands and therefore, discourages taxpayers' motivation towards compliance. Authors suggest that efficient round-the-clock online support services with a strong support system, clear and simple tax returns, and early returns delivery are strategies to enhance filing compliance. In addition, tax authorities could extend the deadline for the return submission and reduce tax rates to ease the tax filing burden during the pandemic.

Reporting Compliance

Taxpayers find difficulties when reporting accurate data as they have to depend on other people and institutes to collect third-party confirmations, letters, and invoices and to prepare schedules and tax calculations as travel restrictions and work from home arrangements. Tax officers should understand the situation before selecting files for detailed audits or issuing excessive assessments. Tax authorities should grant considerable time to business owners to settle with the pandemic and submit additional documents if any. Unless tax officers can cross-check the correctness of the reported data accessing their legitimate power rather than pressurizing taxpayers it may discourage tax compliance. Entrepreneurs need to earn income and it is only then, that they can contribute to government coffers. Tax policymakers should pay special attention to protect medium-sized business owners, as they will be the next large taxpayers in the country. Also, treating entrepreneurs as honest taxpayers will keep them comfortable in a crisis.

Payment Compliance

Taxpayers should comply with different payments such as annual tax payments, default tax payments, and penalty payments but the crisis created cash flow difficulties for the businesses. According to the authors, recovering default tax at this time will be an additional burden to business owners. Therefore, all taxpayers should get the benefit of a grace period to re-schedule their old tax payments. Besides, the study highlighted the importance of avoiding harsh recovery action without giving a chance for taxpayers to discuss financial and administrative difficulties and reschedule their debts. The authors highlight that taxpayers do not declare the correct tax amount if they want to avoid paying tax. Also, they are of the view that the psychological pressure created by imposing collection action may discourage the taxpayers from contributing their fair share in taxes to the government. The author suggests tax administration should avoid sending eleventh-hour notices to taxpayers and permit manageable payment schemes for a shorter period. In addition, the author emphasizes that presenting understandable tax calculations, a clear penalty collection system, and temporary payment settlement approaches will give some relief to medium-sized entrepreneurs.

Sustainable Tax Compliance Culture

The difficult tax administration environment created during the COVID-19 pandemic pushed tax administrators to seek more practical revenue collection approaches. The unexpected issues faced by the entrepreneurs in a crisis has an adverse impact both mentally and physically. Therefore, they need more attention and trust-relationship with tax administrators. As emphasized by the author treating taxpayers equally, respectfully, and listening carefully will increase the level of response to compliance. Besides, the government should be transparent on how the tax money will be utilized in a crisis and why the government needs more funds to manage health and other public welfare commitments at this critical time. Transparent and accountable behaviour of the government and tax authority will build faith in taxpayers. It is important to understand that when the contribution to the government revenue it is decreasing, the more vulnerable groups may suffer. This will lead to lot of taxpayers ignoring their tax obligations. The role of the tax authority is not only to collect and administer tax compliance but also to convince taxpayers and the business community to understand their importance in society as taxpayers. Revising the tax system rather than squeezing and collecting taxes will support the business community to continue their enterprises, so that, they decide to contribute somehow. Conducting online awareness programs and workshops about tax administration and procedures will encourage taxpayers to adhere to tax laws and behave as responsible civic citizens.

Conclusion

The author confirms that the current tax compliance approaches need to be re-designed to adjust to post-COVID-19 circumstances. The identified areas to increase tax compliance are as follows.

- The government and the tax authority should understand taxpayers' difficulties and enhance online services for tax registration, return filing, and payment facilities.
- Easy access to the Inland Revenue Department online system and round-the-clock online taxpayer support service will encourage tax compliance.
- Conduct online training programmes to educate and train officers to approach taxpayers' matters productively.
- Developing a transparent and trustworthy compliance culture so that taxpayers voluntarily comply and trust the authority and the government.
- Tax returns need to be prepared in a simple format, and the returns and pay-in-slips need to be sent to taxpayers without delays.
- Monitoring tax collection and audit procedures are essential to protect medium-sized entrepreneurs until they re-establish their business.
- Awareness of tax law and administration is necessary so that taxpayers understand the consequences of non-compliance and obey tax obligations.
- Communication of taxpayers' issues is required to build an effective tax compliance system.

The results contribute to restructuring the current tax system and developing an efficient post-pandemic tax compliance environment. The insight to tax administrators and policymakers in supporting medium-sized entrepreneurs' tax compliance is as follows;

- Tax officials can contact taxpayers to identify their burdens and constraints. The findings can be used to enhance service support mechanisms and re-structure tax administrative challenges.
- Effective and focused group tax compliance activities, including approaching those playing in the shadow economy, will support medium-sized entrepreneurs and reduce pressure on honest taxpayers while taking action to tackle non-compliant taxpayers.
- Tax administrators could use this opportunity to demonstrate the care and respect they have for taxpayers.
- Policymakers could reduce the frequency of changes in tax legislation and amendments to the legislation until the business owners settle post the crisis.

Even though the research was done using a limited sample size and it did not cover a wide geographical area the author emphasizes the importance of timely assessing taxpayers' perceptions and experiences to improve the effectiveness of tax compliance approaches in Sri Lanka after the pandemic. The author finds that special attention and support will be necessary for small-medium-sized entrepreneurs to remain in the tax system. Revamping old tax compliance methods while introducing new tools will support manage tax compliance in a post-pandemic environment.

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TAX UPDATE: SOCIAL SECURITY CONTRIBUTION LEVY

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Introduction

Social Security Contribution Levy Act, No. 25 of 2022 ("*SSCL Act*") was passed in Parliament on September 08, 2022, and it was certified by the Honorable Speaker on October 20, 2022. According to the SSCL Act, the Social Security Contribution Levy (*"the levy"*) is imposed with effect from October 01, 2022. Though it is a new taxing statute, it is understood that the structure of the SSCL Act is *prima facie* similar to the Nation Building Tax Act which was abolished with effect from January 01, 2020. However, it is pertinent to note that there are some important differences between these two taxing statutes. As an example, NBT Act permits manufacturers to claim NBT paid on certain purchases whereas the SSCL Act does not contain such provisions enabling the claim of input tax. Thus, readers are encouraged to read the SSCL Act with a fresh mind as it could help the identification of such vital differences.

Imposition

The levy is imposed on four types of persons known as "taxable persons" who, "imports any article", "carries on the business of manufacture of any article", "carries on the business of providing a "service" of any description" or "carries on the business of wholesale or retail sale of any article including importation and sale of such article". SSCL is charged from every taxable person for every quarter in respect of the "liable turnover", at the rate of 2.5%. In the SSCL Act, liable turnover is stated as a percentage of turnover. Therefore, the determination of the "turnover" is important in deciding the liable turnover. The below table depicts the meaning of the "turnover" and the "liable turnover" for the purpose of SSCL Act.

	Taxable Person	Turnover	Liable Turnover
Importation	**a) Person who imports any article**	The value of that article ascertained for the purpose of the Value Added Tax under section 6 of the Value Added Tax Act, No. 14 of 2002 (“VAT Act”), but does not include the value of any exempted article As per section 6 of the VAT Act, the value of goods imported (other than the goods as prescribed by regulation) shall be the aggregate of the value of the goods determined for the purpose of customs duty increased by ten per centum; and the amount of any custom duty payable in respect of such goods with the addition of any surcharge, cess, any Port and Airport Development Levy payable under the Finance Act, No. 11 of 2002, and any excise duty payable under the Excise (Special Provisions) Act, No. 13 of 1989 on such goods.	100% of the turnover
Manufacture	**b) Person who carries on the business of manufacture of any article**	The sum receivable whether received or not, in that quarter, of any article manufactured and sold in Sri Lanka by such person other than any exempted article	85% of the turnover
Service	**c) Any person carrying on the business of supplying any financial services**	The sum receivable whether received or not, from the supply in Sri Lanka of any financial Services by any person carrying on the business of supplying any financial services in Sri Lanka but does not include any exempted services.	100% of the Value addition attributable to financial services computed by applying the attributable method referred to in Chapter IIIA of the Value

			Added Tax Act, No. 14 of 2002
	d) Business of real estate and improvement	The value of any service arising from the business of real estate and improvement ascertained under subsection (7) of section 5 of the Value Added Tax Act, No. 14 of 2002 for the purpose of the said Act but does not include exempted services As per subsection (7) of section 5 of the VAT Act, the value of supply of land and improvements thereon, shall be the value of such supply less the value of land at the time of supply and the value of any improvements on the land as at March 31, 1998 which shall not be less than the open market value of such supply excluding the value of such land at the time of supply and the value of any improvements on such land as at March 31, 1998	100% of the turnover
	e) Service providers other than those referred in items c) and d) above.	The sum receivable, whether received or not, from the provision of any service in Sri Lanka other than any exempted services	100% of the turnover
Wholesale or retail sale	**f) Sale of article by a "registered distri butor" in relation to any manufacturer or producer of any goods in Sri Lanka.**	the sum receivable, whether received or not, from the wholesale or retail sale of any article in Sri Lanka other than any exempted article	25% of the turnover
	g) Whole seller or Retail seller other than referred to in item f)		50% of the turnover

Further, in determining the turnover bad debt incurred during the quarter, Value Added Tax included in the consideration and any rebate paid under the Export Development Rebate in relation to any international event as approved by the Minister shall be excluded from the turnover.

Registration

In the case of a taxable person whose aggregate turnover from October 01, 2021, to September 30, 2022 has exceeded Rs. 120 million, registration should be obtained within fifteen days from October 01, 2022. Any other taxable person, registration should be obtained within fifteen days from the date on which the aggregate of the turnover for a quarter exceeds or is likely to exceed Rs. 30 million.

Exemptions

Details of the exempted articles and exempted services are listed in the First Schedule to the SSCL Act. Part IA of the First Schedule provides the exemption on importation or manufacturing of certain articles, Part IB provides the exemptions on the wholesale or retail sale of certain articles, and exempted services are listed in Part II of the First Schedule.

Payments and returns

Other than the levy collected by the Director General of Customs at the point of importation, the levy is payable monthly. The respective returns have to be submitted quarterly. However, Persons who supply financial services shall submit an annual adjustment within 6 months after the closing date of the relevant accounting period.

Conclusion

Any nuisance tax has its own social and economic repercussions. Similarly, with the introduction of SSCL Act also, there will be many repercussions including inflationary effects. Especially as the levy is charged at the importation as well as at the point of sale, the cascading impact is unavoidable despite a certain percentage of turnover being excluded with the motive of minimizing the cascading impact. Further, there are important areas that need further attention of the government including the broader definition given for "manufacture", streamlining of exemptions, inclusion of certain important exemptions, etc. Nevertheless, now SSCL Act is part of the legal system of the country, as such, from the perspective of the business, the most important thing at the moment is the identification of the implications at each level and the implementation of necessary procedures to comply with the law.

DIGITALIZATION OF ECONOMY AND GLOBAL TAX REFORMS

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ABSTRACT

Globalization and digitalization have had a significant impact on economies and people's lives all over the world. This has only grown more pronounced in the twenty-first century. The rules for taxing international business income have faced challenges as a result of these changes. These rules have been in place for more than a century and have prevented MNEs from paying their fair share of taxes in spite of the enormous profits many of these companies have made as the world has become more interconnected. The OECD intensified its efforts to address these issues in 2013 in response to growing political and public concerns about the tax evasion by large multinational corporations. The current regulations still allow big companies to make a lot of money in a country without having to pay corporate income tax in those jurisdictions. It is now simpler for MNEs to move revenues to countries with low taxes thanks to new business models that largely rely on intellectual property. Unhealthy tax competitiveness has worsened as a result of globalization. The Two-Pillar Solution will guarantee that multinational corporations (MNEs) must pay a minimum tax rate and will redistribute the profits of the largest and most successful MNEs among all nations. The Two-Pillar Solution, which creates a new framework for international tax, has now been joined by 136 nations and jurisdictions, accounting for more than 90% of the world's GDP. These nations have also agreed to a detailed implementation plan that calls for the new rules to be implemented by 2023.

List of abbreviations

ICRICT	- Independent Commission for the Reform of International Corporate Taxation
CSO	- Civil Society Organization
DST	- Digital Service Tax
BEPS	- Base Erosion and Profit Shifting
MAP	- Mutual Agreement Procedure
MNEs	- Multinational Enterprises
OECD	- Organization for Economic Co-operation and Development
STTR	- Subject-to-tax rule
FACTI	- Financial Accountability, Transparency & Integrity

INTRODUCTION

At present most countries in the world are in the process of implementing tax reforms based on tax policies post the COVID-19 pandemic and the eminent economic crisis. A significant drive towards digitalization of the economy also requires countries to relook at their tax policies on these new types of products and business models. Globally, most countries are working together to face challenges arising from the digitalization of the economy. According to the Organization for Economic Co-operation and Development (OECD), there are two problems in the existing international tax rules. The previous international tax rules are based on agreements made in the 1920s and are today enshrined in the global network of bilateral tax treaties. These provide that the profits of a foreign company can only be taxed in another country where the foreign company has a physical presence. This is on the premise that most countries will only tax domestic business income of MNEs, but not foreign income, and foreign business profits will be taxed in the country in which it is earned.

The OCED estimates corporate tax avoidance costs to be anywhere from USD 100-240 billion annually, or between 4-10% of global corporate income tax revenues due to the above problems. In October 2021, 136 countries representing more than 90% of global GDP agreed to a global minimum tax plan proposed by the OECD. The OECD has come up with a two-pillar solution to address the tax challenges arising from the digitalization of the economy. Pillar number one ensures a fairer distribution of profits and taxing rights among countries with respect to the largest and most profitable multinational enterprises. Pillar number two introduces a global minimum corporate tax rate at 15% on companies with more than € 750mn in revenue starting from 2023.

OECD’S TWO-PILLAR SOLUTION TO ADDRESS THE TAX CHALLENGES

The global tax deal represents a major reform to the rules governing international tax havens and profit-shifting rules. The deal aims to give countries a fairer chance to collect tax revenues from MNEs operating in or generating revenues from their jurisdictions. The deal specifically aims to address challenges that arise from the digitalization of the economy and is broken down into two pillars as **Pillar One:** Aims to reallocate MNE (Multinational Enterprises) profits and taxing rights to market jurisdictions and **Pillar 2:** Introduces a global minimum tax rate. The negotiations for the OECD tax deal took place within the OECD/G20 Inclusive Framework on BEPS. A total of 140 jurisdictions were part of the Inclusive Framework when the negotiations were taking place. In total, 137 of the 141 member jurisdictions have agreed to the two-pillar solution while Kenya, Nigeria, Pakistan and Sri Lanka chose out.

Pillar 1 - Redistribution of profits and taxing rights

Countries can only tax corporations that have a physical presence within their jurisdiction under the current system of international taxation. Under this scheme many nations have lost their taxing rights from multinationals that earn significant revenue within their borders due to technological improvements that has made it possible for businesses to sell goods and services globally without having a physical presence. As a result, Pillar 1 aims to compel the biggest MNEs to pay taxes to market jurisdictions and reallocate a portion of their income.

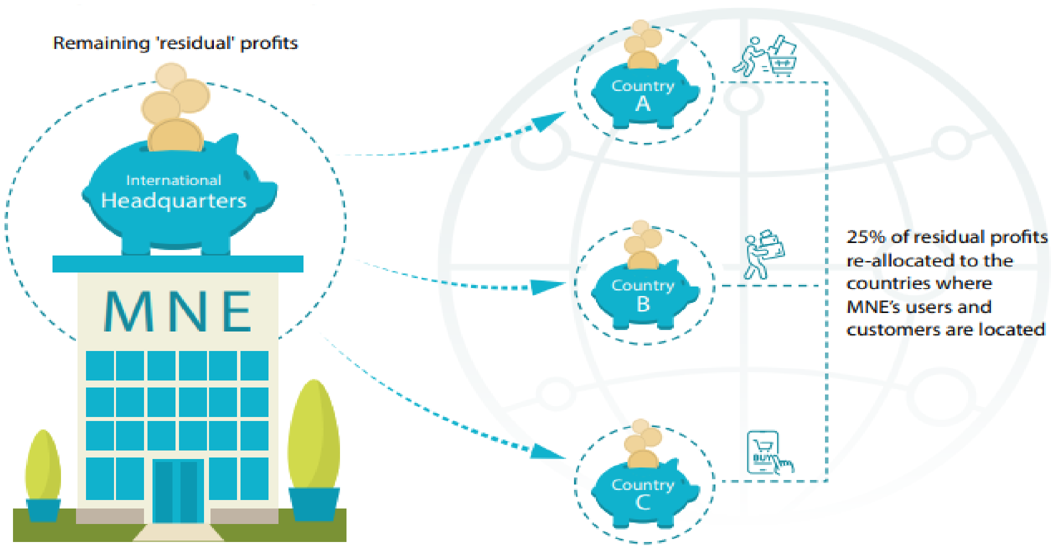
Key Elements

Table 1.

1. **Companies that will come within this rule**	Only 100 of the largest and most successful MNEs—those with global turnover above €20 billion (about US$22.6 billion or UGX 80.7 trillion) and >10% profitability—are included in the study. Excluded are businesses in the extractive and regulated financial services industries. After seven years, there is an option to broaden the scope by lowering the turnover criterion to €10 billion (US$11.3 billion or UGX 40.3 trillion).
2. **Profit to be allocated**	Only 25% of the residual profit made by an in-scope entity is subject to the reallocation criterion. This is known as "Amount A." Taxable profits that exceed a 10% profit margin are referred to as residual profits.
3. **Expected tax revenue**	It is anticipated that each year, more than US$125 billion (UGX 445 trillion) in earnings will be taxed by market jurisdictions.
4. **Jurisdictions benefits**	Places where the in-scope MNE generates at least €1 million in revenue (US$1.13 or UGX 4 billion). The nexus will be set at €250,000 (US$283,000 or UGX 1 million) for smaller jurisdictions with a GDP below €40 billion (US$45.3 billion or UGX 161.4 trillion). **Advantages:** **<u>Fairer distribution of profits and taxing rights</u>** • The rule mandates that MNEs pay taxes in the regions where their customers and sales are made. Pillar 1 inhibits multinational enterprises (MNEs) from evading their tax obligations in market jurisdictions, which are frequently developing nations. **Disadvantages** **<u>Too many MNEs out-of-scope</u>** • Companies engaged in the extractive industry are also not included in the agreement, despite the fact that it has been noted that this business is particularly vulnerable to illicit cash flows. **<u>Limited impact for developing countries</u>** • Only a small fraction of the profits (25% of "residual profits" above 10% profitability) of the approximately 100 qualifying firms are subject to the reallocation requirement (those with more than 20 billion euros in profit).

	• According to Oxfam, this would only bring in an annual revenue of US$140 million (UGX 500 billion) for low-income nations and US$8 billion (UGX 28.5 trillion) for middle-income countries. • It is unclear that this will result in structural changes in the distribution of corporation taxes globally, and it might not even be worth the implementation expenses for the smallest emerging nations.
5. **Requirement to give up Digital Services Tax**	The agreement stipulates that all unilateral measures, such as the digital services tax (DST) imposed on non-resident companies, must be repealed by the nations and jurisdictions that signed it, and that no new taxes of this kind may be enacted between October 31, 2021, and December 31, 2023, while the agreement is in effect. **Advantages:** **<u>Stability in the international tax system</u>** • DST are unilateral taxes that have been enacted by nations like Kenya to tax the digital services offered by businesses there that do not have a physical presence. • The elimination of DST intends to prevent both double taxation and the possibility of trade disputes since these target enterprises will now be taxed under pillar 1. **Disadvantages:** **<u>Robs developing countries of tax revenue</u>** • While Pillar 1 corporations have a restricted scope, all MNEs, even corporations that are not covered by Pillar 1, must eliminate unilateral measures like DST. • It revokes the authority to enact future unilateral actions. • As a result, in some circumstances, signing away DST may be more expensive for countries than the financial benefits they stand to earn from pillar 1 of the agreement. • Kenya's rejection of the contract was mostly due to this component. Only eleven Kenyan enterprises will fall under the purview of pillar 1 notwithstanding Kenya's 1.5% DST, which covers 89 companies.
6. **Mandatory dispute resolution**	Mandatory and enforceable dispute prevention and resolution processes will assist in-scope MNEs by preventing double taxation on "Amount A".

	However, developing nations who haven't seen appreciable numbers of MAP disputes under the BEPS framework will have access to a voluntary binding dispute settlement system. **Advantages**:- **<u>Tax certainty and elective mechanism</u>** • The required dispute prevention and resolution process addresses the possibility of double taxation, enhancing tax predictability. The voluntary mechanism is offered in order to make sure that low-capacity nations are not overburdened by the restrictions. **<u>Disadvantages</u>**:- **<u>Mandatory for some limited capacity countries</u>** • Not all poor nations with low capacity will be able to qualify since the binding dispute resolution aspect is only offered as an elective if specific requirements are met. • One of the factors that led Kenya and Nigeria to reject the agreement was the requirement for dispute resolution because they were worried about losing sovereignty if tax disputes had to be settled in the country of residence.



Picture 01: Pillar one solution

Pillar 2 - Global Minimum Tax Rate

Countries have been battling the issue of MNEs evading taxes by moving their headquarters to low-tax jurisdictions or tax havens for a very long time. Pillar 2 introduces a global minimum tax rate to solve this.

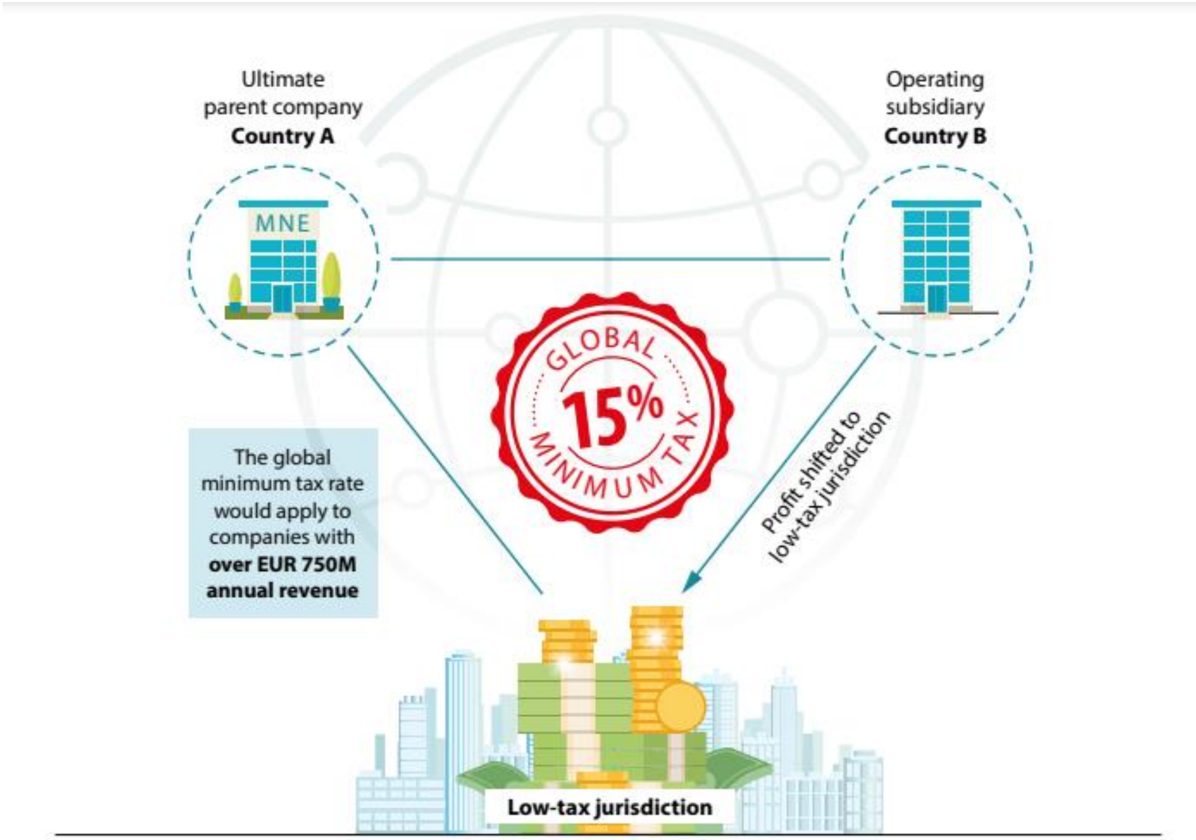
Key Elements

Table 2.

1. **Minimum tax rate**	A global minimum corporate tax rate of 15%. It is predicted that this will increase annual global tax receipts by about US$150 billion (UGX 534 trillion).
2. Companies that will come within this rule	Any business with yearly sales of more than €750 million (US$850 million or UGX 3 trillion) will be subject to the minimum rate. Exempted entities include any holding vehicles utilized by government entities, international organizations, non-profits, pension funds, investment funds, and funds that are Ultimate Parent Entities (UPE) of an MNE Group. **Advantages**: **<u>Eliminates tax havens and tax competition</u>** • The global minimum tax rate diminishes the motivation for MNEs to move their profits to nations with no or low corporate income taxes, and it lessens the pressure on (developing) nations to provide tax advantages to draw foreign investment. **Disadvantages:** **<u>The 15% rate is too low</u>** • The average corporate tax rate worldwide is close to 25%, although some nations, like Nigeria, impose rates of 30% or higher. • Therefore, a 15% rate will maintain the incentives for tax rivalry and evasion. Since the Independent Commission for the Reform of International Corporate Taxation (ICRICT) and FACTI Panel both suggested higher rates of 25% and 20–30%, respectively, many CSOs believe it to be insufficient.

2. **Jurisdictions benefit from collecting the tax**	The nation or territory where the corporation has its headquarters, or residence jurisdiction, will be responsible for collecting the minimum tax rate. The Residence nations may levy a "top-up tax" on a subsidiary of an MNE that is subject to a lower tax rate in another jurisdiction in order to recover the difference in uncollected taxes. The agreement does not mandate that jurisdictions set their rates at 15%. **Advantages**: **Easy administration** • The regulation is simpler to implement because each multinational will only have to pay tax in one country as a result of residence jurisdictions having the priority to charge the "top up" tax. **Disadvantages:** **Unfair to developing countries** • Bulk of MNEs have their headquarters in high-income nations, the revenue generated under pillar 2 will disproportionately benefit these nations. • The G7 and EU countries will receive more than two-thirds of the earnings, while the countries with the lowest incomes will only receive 3%, according to Oxfam's calculations. This is seen to be especially unfair because low-income countries often rely more heavily on corporate income tax as a source of revenue but will not benefit as much from this rule.
3. **Subject-to-tax rule (STTR)**	The STTR will let source jurisdictions, or the countries and jurisdictions where operations are conducted, to continue to tax some base-eroding payments made by businesses to related parties abroad, such as royalties and interests that are exempt from withholding taxes because of tax treaties. The STTR mandates that member nations that tax interest and royalties at a rate below 9% of corporate revenue amend their bilateral agreements with developing nations to permit them to do so. **Advantages**: **Addresses concerns of unfair allocation** • When payments to connected parties abroad, such as interest and royalties, are not taxed at the minimum rate of 9%, the STTR protects the source jurisdictions' (often developing countries') ability to tax those payments.

	• This somewhat allays some of the worries that underdeveloped nations are treated unfairly by the preference given to residency jurisdictions under pillar 2. **Disadvantages**: **A weak consolation prizes** • Given that the STTR is less than the 15% minimum rate and "does not safeguard countries against base erosion through inflated interests or royalties contained in the cost of goods supplied," CSOs saw it as a "poor consolation prize." Additionally, signing of new treaties with tax havens is necessary for the implementation of the STTR.
4. **Substance carve-outs**	• The substance carve-out rule's exemption of some low-taxed activities with actual substance, the tax base on which the 15% minimum rate will be applied will be reduced. • In particular, a business will be able to subtract 5% of the tax base that the home jurisdiction can use to charge the top-up tax from the cost of staff salaries and tangible assets. **Advantages**: **<u>Allows tax incentives for genuine foreign investment</u>** • The substance carve-out rule permits nations to continue to provide incentives that draw real and significant business activities, such as constructing hotels or investing in factories. • It is consistent with the goal of preventing artificial profit-shifting because it only applies to legitimate economic activity. **Disadvantages**: **<u>Risk defeating the purpose of a minimum rate</u>** • Companies might avoid paying the minimum rate thanks to substance carve-outs if they have enough activities (assets and personnel), say in a tax haven. • It might undermine the minimum rate's goal of limiting tax competition by incentivizing businesses to move their operations to countries with low tax rates.



Picture 2: Pillar two solution

IMPACT ON TAX REVENUE

The OCED has stated that the implementation of the two pillar solution will impact the revenue as follows

- Under Pillar One, taxing rights on more than USD 125 billion of profit are expected to be reallocated to market jurisdictions in each year.
- Under Pillar Two, the global minimum tax, with a rate of 15%, is expected to generate around USD 150 billion in new tax revenues globally per year.

TARGET DEADLINES

The Detailed Implementation Plan with the target deadlines as follows:

Table 3.

Pillar One	Pillar Two
Early 2022 – Text of a Multilateral Convention (MLC) and Explanatory Statement to implement Amount A of Pillar One	**November 2021** – Model rules to define scope and mechanics for the GloBE rules
Early 2022 – Model rules for domestic legislation necessary for the implementation of Pillar One	**November 2021** – Model treaty provision to give effect to the subject to tax rule
Mid 2022 – High-level signing ceremony for the Multilateral Convention	**Mid 2022** – Multilateral Instrument (MLI) for implementation of the STTR in relevant bilateral treaties
End 2022 –Finalisation of work on Amount B for Pillar One	**End 2022** – Implementation framework to facilitate co-ordinated implementation of the GloBE rules
2023 – Implementation of the Two-Pillar Solution	

BENEFITS TO DEVELOPING COUNTRIES

The OECD has estimated that on average, low, middle, and high-income countries would all experience revenue gains as a result of Pillar One, but these gains would be expected to be larger (as a share of current corporate income tax revenues) among low-income jurisdictions. Overall, the GloBE rules will relieve pressure on developing countries to provide excessively generous tax incentives to attract foreign investment; while at the same time, there will be carve-outs for activities with real substance.

- Subject to tax rule (STTR), which prevents companies from avoiding tax on their profit earned in developing countries by making deductible payments such as interest or royalties that benefit from reduced withholding tax rates under tax treaties and which are not taxed (or taxed at a low rate) under the tax laws in the treaty partner; this will help developing countries protect their treaty networks from abuse through profit shifting to low tax jurisdictions.
- Simplified and streamlined approach to the application of the arm's length principle to in-country baseline marketing and distribution activities, as low-capacity countries often struggle to administer transfer-pricing rules and will benefit from a formulaic approach in those cases.
- Lower threshold for determining the re-allocation of profit under Pillar One to smaller economies

OCED IMPLEMENTATIONS IN SRI LANKA

Even though Sri Lanka is a member of the OCED, it is still yet to agree to join the agreement because it has asked for more time to decide. The main reason for this is that Sri Lanka has offered tax incentives and tax holidays for Foreign Direct Investments to attract more investment to country. For example, since Sri Lanka had already offered a 40-year tax holiday for multinational companies that invest in the Colombo Port City in terms of the Colombo Port City Economic Commission Act, agreeing to certain clauses in this agreement would be difficult.

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