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Clarification on Whether “Negative Reserves” Can Be Considered in the Computation of the Limit Specified in Section 18 of the Inland Revenue Act, No. 24 of 2017 (as Amended)

This instruction is issued in response to clarifications sought by taxpayers and tax officials regarding the meaning of “reserves” as clarified by the Commissioner General for the purposes of Section 18 of the Inland Revenue Act, No. 24 of 2017 (as amended) (hereinafter referred to as “IR Act”), particularly in circumstances where a company reports negative reserves or a debit balance in retained earnings.

Background Information

Section 18 of the IR Act restricts the deductibility of finance cost expenditure, (interest and losses on financial instruments), incurred by limited liability companies in respect of financial instruments, by reference to the level of equity capital and loan capital of the company.

This provision operates as an internal anti-avoidance measure intended to address situations where companies finance their subsidiary companies through loans rather than equity capital. This is because interest paid on loans is generally deductible for tax purposes, whereas returns on equity are distributed as dividends, which do not qualify as deductible expenses for tax purposes.

Under the calculation prescribed in the repealed Inland Revenue Act, No. 10 of 2006 the interest restriction applied only to companies within a group. However, the prevailing IR Act has expanded the scope of the restriction to cover all limited liability companies (other than financial institutions). The formula for calculating the finance cost restriction under the prevailing Act is as follows:

$$\frac{A}{B} \times C$$

Where:

‘A’ = financial cost of the year;

‘B’ = value of financial instruments on which the financial cost incurred during the year; and

‘C’ = 4 x total of the issued share capital and **reserves** of the company as at the end of the year.

Financial cost amount calculated from the above formula is allowed as a deduction while any balance incurred during the year is disallowed and be carried forward as provided in the Section 18(3) of the IR Act.

The issue arises in determining the value of reserves, particularly where the combined balance of issued share capital and reserves is negative due to accumulated losses. If accumulated losses are treated as a negative reserve for the purpose of the calculation, the aggregate of issued share capital and reserves may become negative. In such circumstances, the allowable finance cost would be reduced to zero, resulting in the entire finance cost expenditure being disallowed.

However, the taxpayers' position was that reserves should be regarded as a positive balance and, where no reserves exist, the value of reserves should be treated as zero rather than as a negative amount. Accordingly, the aggregate of issued share capital and reserves would be equal to the value of the issued share capital. This amount could then be multiplied by four to determine the permitted level of debt, and the corresponding deductible finance cost expenditure could be calculated.

This issue had also arisen under the repealed Inland Revenue Act, No. 10 of 2006. Despite the continuation of the Inland Revenue Department's (IRD) position on the matter, a court decision was subsequently issued in favour of the taxpayer in the Samson Rajarata case (CA No. CA/TAX/0008/2015 Tax Appeals Commission No. TAC/IT/023/2013 Samson Rajarata Tiles (Pvt) Ltd. vs. Commissioner General of Inland Revenue.). The Court of Appeal held that, in the absence of a specific definition of "reserves" in the Act, the taxpayer's position that reserves represent a positive balance should be accepted.

Since the court decision is final and binding, it should be accepted for the purposes of the repealed Act in respect of similar cases. However, cases currently at the appeal stage under the provisions of the new IR Act have been appealed by the IRD, taking into consideration the differences between the provisions of the two Acts.

Nevertheless, the new IR Act also does not provide a definition of the term "reserves." Accordingly, the Inland Revenue Bill 2026 initially proposed introducing a definition of "reserves" that would expressly include negative balances in reserve accounts.

Inland Revenue Bill 2026 was drafted a clause as follows.

"4. Section 18 of the principal enactment is hereby amended by the repeal of subsection (5) of that section and the substitution therefor, of the following subsection: -

(5) For the purpose of this section -

(a) "reserves" includes negative retained earnings, accumulated losses or deficits in reserves, but excludes reserves arising from the revaluation of any asset; and

(b) where an entity has negative retained earnings, accumulated losses or deficits in reserves, "the total of the issued share capital and reserves of the entity" shall be calculated taking into account such negative retained earnings, accumulated losses or deficits in reserves."

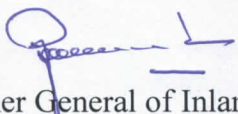
However, the above proposed definition was removed at the Committee Stage following numerous representations made by taxpayers, particularly those in the SME sector and business startups. Accordingly, there is currently no definition of the term "reserves" in the IR Act as contemplated by the proposed amendment. In the circumstances, it must be accepted that the interpretation of the term "reserves" given by the Honorable Court of Appeal in CA No.

CA/TAX/0008/2015, Tax Appeals Commission No. TAC/IT/023/2013, Samson Rajarata Tiles (Pvt) Ltd. v. Commissioner General of Inland Revenue, should also apply for the purposes of the IR Act, since the proposed amendment introducing the above definition was subsequently withdrawn.

Clarification

As explained above, hereinafter, for the purposes of applying Section 18 of the IR Act, **where there are negative retained earnings, accumulated losses, or deficits in reserves, such negative balances should be treated as having a value of “Zero” when calculating the total of the issued share capital and reserves of the company as at the end of the relevant year, and thereafter determining the limit specified in Section 18(2) of the IR Act.**

This position may be applied in ongoing tax audits, administrative review decisions, and appeals where a similar issue is currently pending.


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