INCOME TAX
WEALTH TAX
and
GIFTS TAX
in
Sri Lanka

SECOND EDITION

S. BALARATNAM BA. ACMA.

150/-

Chapter 1

THE CHARGE OF INCOME TAX

The charge of income tax is imposed by the Inland Revenue Act No. 28 of 1979 as amended by Inland Revenue (Amendment) Acts No. 24 of 1980, 40 of 1981 and 27 of 1982. This Act as amended by subsequent amendments provides the legal authority for the imposition of income tax on the profits and income of every person. The charge of income tax is based on the profits and income of every person which arose or is derived during an year of assessment. An year of assessment is the period of twelve months commencing on the first day of April of an year and ending on the thirty first day of March in the immediately succeeding year. S. 163. That is, for example, the period commencing from first April 1982 and ending on thirty first day of March 1983 is called the year of assessment 1982/83.

The source of profits or income and the person on whom tax is charged on that profits or income must be clearly found in the Act, as otherwise no liability to tax would arise.

"No subject can be taxed, unless the Crown can find a clearly charging Section, and once that is found, the subject cannot escape taxation unless he can find a clearly exempting Section."

Lord Justice Clerk.

A person can be charged with tax not by inference or analogy, but only by the plain words of the taxing Act applicable to the facts and circumstances.

In a recent decision of the House of Lords in the case of *Ramsay v. C.I.R.* and *Rawlings v. Eilbeck* Lord Wilberforce reviewed the principles adopted by Courts in interpreting the taxing statutes and identified four basic rules of construction in interpreting the taxing statutes as follows:–

(i) "A subject is only to be taxed upon clear words, not upon "intendment" or upon the "equity" of an Act. Any taxing Act of Parliament is to be construed in accordance with this principle. What are "clear words" is to be ascertained upon normal principles: these do not confine the courts to literal interpretation. There may, indeed should be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded.

(ii) A subject is entitled to arrange his affairs so as to reduce his liability to tax. The fact that the motive for a transaction may be to avoid tax does not invalidate it unless a particular enactment so provides. It must be considered according to its legal effect.

(iii) It is for the fact-finding commissioners to find whether a document, or a transaction, is genuine or a sham. In this context to say that a document or transaction is a "sham" means that while professing to be one thing, it is in fact something different. To say that a document or transaction is genuine, means that, in law, it is what it professes to be, and it does not mean anything more than that.

(iv) Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. This is the well known principle of *I.R.C. v. Duke of Westminster* (1936) A.C. 1. This is a cardinal principle but it must not be overstated or over-extended. While obliging the court to accept the documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole there is nothing in the doctrine to prevent it being so regarded: to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.

The case involved an avoidance scheme of two separate transactions which sought to create an allowable loss in one transaction in order to offset a capital gain in the other transaction, although in the final result the scheme did not involve the taxpayer in a little or no loss at all The House of Lords held that the scheme was artificial and fiscally ineffective.

This decision is a new approach to the established doctrine of 'form and substance' which laid down that given the document or transaction is genuine, the courts cannot go behind it to some supposed underlying substance: *Duke of Westminister v. CIR:* 19 TC 490. The effect of the new approach is that the Courts could examine the overall effect of an avoidance scheme or arrangement and cannot be compelled to examine each transaction separately but may collectively consider the component part of the single scheme or arrangement.

"I have a full respect for the principles which I have stated but I do not consider that they should exclude the approach for which the Crown contends. That does not introduce a new principle; it would be to apply to new and sophisticated legal devices the undoubted power and duty of the courts to determine their nature in law to relate them to existing legislation. While the techniques of tax avoidance progress and are technically improved, the courts are not obliged to stand still. Such immobility must either result in a loss of tax, to the prejudice of other tax-payers, or to Parliamentary congestion or (most likely) to both. To force the courts to adopt, in relation to closely integrated situations, a step by step, dissecting, which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process. In each case the facts must be established, and a legal analysis made: legislation cannot be required or even be desirable to enable the Courts to arrive at a conclusion which corresponds with parties' own intentions".

Lord Wilberforce in Ramsay v. C.I.R. 1980 H.L.

1. Persons Chargeable with Income Tax

A person is defined to include a Company or Body of Persons or any Government. S. 163. A body of persons is defined to include any local or public authority, any body corporate or collegiate, any fraternity, fellowship association or Society of persons, whether corporate or unincorporate and any Hindu 'Undivided family' but does not include a company or partner ship. S. 163.

The following persons are therefore chargeable with income tax:

(a) an individual;
(b) a company;
(c) a trust;
(d) a charitable institution;
(e) a Co-operative Society;
(f) a Hindu Undivided Family;
(g) an Executor or Administrator of the estate of a deceased person:
(h) associations or clubs or a society of persons whether corporate or unincorporate;
(i) any local or public authority;
(j) Governments.

A partnership, however, is not a person chargeable with income tax. Each partner is assessable on the share of the profits of the partnership. It is, however, lawful for an assessment to be made in the name of the Partnership under certain circumstances. S. 66(1).

2. Profits and Income. S.3.

There is no definition of what is profits and income that is chargeable with income tax. The charge of income tax is extended to the following sources of income described under the meaning of profits or income:

(a) Profits from any trade or business;
(b) Profits from any profession or vocation;
(c) Income from any employment;
(d) Income from property under the head as Rents and Net Annual Value;
(e) Dividends;
(f) Interest or Discounts;
(g) Royalties and Premiums;
(h) Capital Gains;
(i) Charges or Annuities;
(j) Income from any other source not including profit of a casual and non-recurring nature.

In the absence of any definition of what is termed income in the Act, the principles to be adopted "must be determined in accordance with the ordinary concepts and usages of mankind, except in so far as the statute states or indicates an intention that receipts which are not income, or that special rules are to be applied for arriving at the taxable amount of the receipt."

The profits and income chargeable with income tax is the net profits or income from any source for any period calculated in accordance with the provisions of the Inland Revenue Act. S. 163. Therefore, in determining the amount of the profits or income chargeable with income tax, commercial practices and principles will be applied subject to the overiding application of the tax law.

> "In determining whether a particular item may or may not be deducted from profits it is necessary first to inquire whether the deduction is expressly prohibited by the Act and then if it is not so prohibited, to consider whether it is of such a nature that it is proper to be charged against incomings in computation of the balance profits and gains for the year" Viscount Cave in *Atherton v. British Insulated & Helsby Cables Ltd.* 10 TC 155.

The sources of profits or income described are mutually exclusive and the question whether a source will be treated as profits or income will depend on whether we are dealing with profits of a business or the income of an individual. In dealing with the question of the source under which income from dividend and interest are assessable Soertsz J. in the case of Financial Investments Ltd. CIT 1 CTC at page 252 said.

> "If it is a case of dividends, interests or discounts appertaining to a business, they fall within the words "Profits of any business" and .... Section 6(1)(a) applies. If however, it is a case of dividends, interest or discounts accruing to an individual not in the course of a business, but as part of his income from simple investments, then section 6(1)(c) is the relevant section............"

Sections 6(1)(a) and 6(1)(c) of the Income Tax Ordinance are similar to sections 3(a) and 3(d) of the Inland Revenue Act No. 28 of 1979.

> "In the case of dividends, interest, discount are not specified either as "profits" or "income" for the reason – I infer-that it would depend on the circumstances of a particular case whether the things mentioned...... are to be treated as profits or income". Soertsz J. Discussing further Soertsz J. – said –

> "The word "profits" and the word "income" are, clearly not synonymous, and an examination of the wording of the Ordinance show that they are not to be used inter-changeably or indiscriminately but that the legislature has employed them with great deliberation. The Ordinance speaks of "profits and income" of "profits" and of "income" indicating thereby that the taxable subject matter may consist in one case, of both profits and income as understood in the Ordinance, in a second case of profits alone, and in a third case of income alone" ....

Where a source falls both as "profits" and as "income" the Revenue has the option to choose between the various sources under which they are chargeable: 1 CTC 206: 1 CTC 37.

The profits and income chargeable with income tax is the net profits or income from any source for any period calculated in accordance with the provisions of the Act. S. 163. The general rules of computation apply to all sources of income with modifications with regard to income from interest, rent and net annual value: S. 24(3) and S. 23 (4).

Where any of these sources are regarded as profit of a trade or business the restrictions on deductible expenditure in the computation of such profits will not apply.

"As I have already submitted, dividends and interest may well be the income of an individual from simple investments, and sub-section (3) is careful to enforce disallowance in regard to interest that is part of income but not in regard to interest that is part of profits"–

(Soertsz J. 1 CTC P 254)

The sub-section (3) referred to is 9(3) of the Income Tax Ordinance the wording of which is similar to Section 23(4) of the Inland Revenue Act No. 28 of 1979.

3. **Effect of Residence of a Person.**

All profits or income arising in or derived from Sri Lanka are sought to be taxed together with foreign sources of profits and income derived by persons resident in Sri Lanka.

Resident Person:– A person who is considered to be resident in Sri Lanka for tax purposes is chargeable with income tax on the profits and income wherever arising. S. 2(1)(a). That is, a resident person is chargeable with income tax on his world income – income from Sri Lanka and income outside Sri Lanka.

Non-Resident Person:– A person who is considered non-resident for tax purposes is chargeable with income tax on the profits and income arising in or derived from Sri Lanka. S. 2(1)(b).

Profits and income arising in or derived from Sri Lanka include all profits and income:

(a) derived from services rendered in Sri Lanka;

(b) from property in Sri Lanka;

(c) from business transacted in Sri Lanka; either directly or through an agent. S. 2(2).

4. **Measure of profits and income**.

The measure of profits or income chargeable with income tax is profits or income for an year of assessment determined in accordance with the provisions of the Inland Revenue Act. A year of assessment is the period of twelve months commencing from the first day of April of any year and ending on the thirty first day of March in the immediately succeeding year. S. 163.

Profits and income arise on a particular date or accrue over a period of time.

A dividend income arises on the date the company declares the dividend, while interest income accrues over a period of time. Therefore, the measure of profits and income for a particular year of assessment is the amount of the profits and income which arise or accrues or is derived during an year of assessment.

5. **Statutory Income.** S 25

Statutory income is the profits or income from all sources of profits and income determined in accordance with the provisions of the Inland Revenue

Act and practice prevailing. The total statutory income of the person for any year of assessment is the aggregate of his statutory income for that year of assessment from every source of his profits and income in respect of which tax is charged. S. 27.

6. Basis of computing Statutory Income

The statutory income of any person for each year of assessment is the full amount of the profits or income which was derived by him or arose or accrued to his benefit from such source during that year of assessment notwithstanding that he may have ceased to possess such source or that such source may have ceased to produce income. S. 25(1).

Any person carrying on a trade, business, profession or vocation is required to make up the accounts of that trade, business, profession or vocation for each successive period of twelve months ending on the thirty first of March each year. S. 25(2).

7. Basis of making up accounts in the year of commencement

Where any person commences any trade, business, profession or vocation such person must make up accounts in respect of such trade, business, profession or vocation for the period from the date of commencement to the end of thirty first March of that year of assessment. For example, where a person commenced a business on October 1, 1982, he shall make up accounts for the period commencing on October 1, 1982 to the end of March 31, 1983. He must thereafter continue to make up accounts for each successive period of twelve months ending on thirty first day of March each year. S. 25(2)(a).

8. Basis of making up accounts in the year of Cessation

Where a person ceases to carry on any trade, business, profession or vocation in any year of assessment he shall make up the accounts of such trade, business, profession or vocation for the period beginning from the first day of April of that year of assessment and ending on the date of cessation. For example, where a person ceased business on September 30, 1982, he shall make up accounts for the period April 1, 1982 to September 30, 1982. S. 25(2)(b).

9. Making up of accounts to a date other than thirty first of March

Any person who is unable to make up accounts for each year ending on thirty first of March, may give notice to the Commissioner General of Inland Revenue setting out the reasons for his inability to make up accounts to a date ending on thirty first of March. Where the Commissioner General of Inland Revenue is satisfied with the reasons set out, he may direct such person to make up accounts of that trade, business, profession, vocation for such periods as may be specified by him. S. 25(3). He may, at any time revoke such direction.

State Corporations and Cooperative Societies have been permitted by the Commissioner General of Inland Revenue to make up accounts to a date other than thirty first of March.

10. **Apportionment of Profits or Losses**

It is lawful to make any division, apportionment, or aggregation of profits or losses made up to any period in order to compute the statutory income for any year of assessment in respect of any trade, business, profession, vocation, or employment. Any apportionment of the profits or losses for any period for which accounts have been made up shall be on the basis that such profits or losses accrued evenly over that period. S. 26.

11. **Determination of Assessable Income**

Assessable income of any person for an year of assessment is the residue of the total statutory income of any person after deducting the aggregate amount of the deductions in respect of the following S. 163.

(a) Annuity;
(b) Ground rent;
(c) Royalty;
(d) Interest;
(e) Losses.

However, no deductions are permitted to be made from the assessable income in respect of any sum payable by way of interest, ground rent, or royalty by a person out of Sri Lanka to another person out of Sri Lanka. S. 29(2)(a) (i).

12. **Carry forward of deduction in excess of the Statutory Income**

Where for any year of assessment any sum payable by way of annuity, ground rent, royalty or interest exceed the total statutory income of that year, such excess is treated as a loss incurred in a trade, and such loss is carried forward and set off against the statutory income of the next succeeding year and so on. S. 29(2)(a)(ii).

13. **Refusal of deduction from Statutory income by an Assessor**

At the time of making an assessment an Assessor finds that any sum payable by way of interest, annuity, ground rent or royalty has not been paid he may refuse to allow any deduction in respect of that sum from statutory income. S. 29(2)(a)(iii). Where the deductions in respect of the sums payable which has been refused by an Assessor has been subsequently paid, he shall on application made to him in writing within twelve months of making the payment and on production of evidence of payment to his satisfaction revise the assessment notwithstanding that the assessment has become final and conclusive. An assessment is final and conclusive where no valid appeal has been made and has been settled on appeal. Any tax which is found to have been paid in excess as a result of such amended assessment will be refunded, notwithstanding that a claim for repayment has not been made within the prescribed time limit. S. 29(2)(a)(iv).

14. **Determination of Taxable Income.**

Taxable income of a person for an year of assessment is the residue of the assessable income of a person after deducting the aggregate amount of any allowances to which such person is entitled to for that year of assessment. S. 163.

15. **Allowances which a Resident Individual non-Citizen employee and a charitable institution can deduct from his assessable income**

An individual who is resident in Sri Lanka, a non-citizen employee[1] and a charitable institution is entitled to the following deductions from his assessable income:

(a) an allowance of Rupees Twelve thousand; and

(b) an allowance in respect of any qualifying payments made by him in the year of assessment.

Deductions in respect of qualifying payments which an individual, non-citizen employee or a charitable institution is entitled to deduct from his assessable income is discussed in Chapter 33.

An individual who is a trustee, receiver, executor or liquidator is not entitled to deduct an allowance of rupees twelve thousand in ascertaining his taxable income as a trustee, receiver, executor or liquidator. S. 30(i).

16. **Allowance which a person other than an individual or a charitable institution can deduct from the assessable income.**

A person other than a resident individual or a charitable institution is entitled to deduction only in respect of any qualifying payment made in any year of assessment. The quantum of qualifying payments which such person can make is discussed in Chapter 33.

17. **Computation of Tax Payable**

Income tax payable by any person is calculated by applying the appropriate rate or rates of tax applicable on such person on his taxable income of the particular year of assessment.

---

1. 24 of 1980.

Chapter 2

RESIDENCE OF AN INDIVIDUAL

An individual would mean a natural person, that is, a human being. An individual will include an incapacitated person, that is, any minor, lunatic, idiot or person of unsound mind. S. 163.

An individual can be either resident or non-resident of Sri Lanka. The residence of an individual will depend on:

(a) the period of stay in Sri Lanka from the date of his arrival: and

(b) his absence from Sri Lanka and the period of his absence.

1. Rules for the determination of residence.

The basic rules for determining whether an individual is resident or non-resident of Sri Lanka can be summarised as follows:

Deemed Resident

(a) Where the period or periods of stay in Sri Lanka in the aggregate exceed six months (183 days) during the year commencing from the date of his arrival:

(i) if he is in Sri Lanka at the end of the year of his arrival he will be deemed to be resident throughout that year.

(ii) if he is not in Sri Lanka at the end of the year of his arrival, is deemed resident from the date of his arrival to the date of his last departure. S. 67(2).

(b) An individual who has been deemed resident for any period in the year of his arrival is absent from Sri Lanka for less than three months (91 days) will be deemed to be a resident of Sri Lanka during the period of such absence. S. 67(4).

(c) An individual who was deemed to be resident for twenty four consecutive months will be deemed to be a resident if he is not absent from Sri Lanka for an unbroken period of twelve months. S. 67(3).

Deemed Non-Resident

(a) Where the period or periods of his stay in Sri Lanka from the date of his arrival to the date of his departure in that year does not exceed six months (183 days) such individual will be deemed to be non-resident S. 67(2).

(b) An individual who was deemed to be resident for any period in the year of his arrival as a resident is absent from Sri Lanka for a period of more than three months (93 days) will be deemed non-resident from the date of such last departure. S. 67(4).

(c) An individual who has been deemed to be a resident for twenty four consecutive months is absent from Sri Lanka for an unbroken period of twelve months will be deemed to be non-resident from the date of his departure. S. 67(3).

(d) An individual who is not a citizen of Sri Lanka is deemed non-resident for a period of three years from the date of commencement of his employment. S. 67(7).[1]

1. 24 of 1980

Example I.

The arrivals to and departures from Sri Lanka of Mr. X is as follows:

Arrival	Departure	
01.01.1981	31.03.1981	90 days
01.05.1981	30.09.1981	153 days
		243 days

Mr. X was not in Sri Lanka at the end of the year, i.e. 31.12.1981, and his period of stay in Sri Lanka in the aggregate exceeds six months, he will be deemed resident from the date of arrival to the date of his departure, i.e. 01.01.1981 to 30.09.1981.

Example II.

The arrivals to and departures from Sri Lanka of Mr. Y is as follows:

Arrival	Departure	
01.01.1981	31.03.1981	90 days
01.05.1981	30.09.1981	153 days
30.11.1981		
		243 days

Mr. Y will be deemed to be a resident from 01.01.1981 to 30.11.1981 and till he leaves again. The period 01.10.1981 to 30.11.1981 will be deemed to have been spent in Sri Lanka since he was deemed resident from the date of his arrival to 30.09.1981 and that his absence from Sri Lanka is less than three months.

Example III.

Arrivals to and departures from Sri Lanka of Mr. Z is as follows:

Arrivals	Departures	
01.01.1981	31.03.1981	90 days
01.05.1981	30.06.1981	61 days
		151 days

Mr. Z's stay in Sri Lanka was less than six months in that year and therefore he will be deemed non-resident, since he did not come back to Sri Lanka after 30.06.1981 and before 31.12.1981.

Example IV.

Arrivals to and departures from Sri Lanka of Mr. A is as follows:

Arrivals	Departures	
01.01.1981	31.03.1981	90 days
01.05.1981	31.08.1981	123 days
		213 days
10.12.1981	30.12.1981	20 days

Mr. A will be deemed resident for the period 01.01.1981 to 31.08.1981 and non-resident for the period 01.09.1981 to 31.12.1981. The taxpayer was absent from Sri Lanka for more than three months (91 days) after he was deemed to be resident from 01.01.1981 to 31.08.1981.

2. **Modification in the rule for determining residence of Individuals.**

The rules for the determination of residence of individuals are modified in the following circumstances:

(a) **Employees of the Government of Sri Lanka resident abroad for the purpose of their employment. S. 67(5).**

An employee of the Government of Sri Lanka who is resident in any other country, for any period, for the purpose of employment, and the spouse of such individual is deemed to be resident of Sri Lanka, if income tax is not payable by him in the country of his residence in respect of his official emoluments payable to him for such period.

However, an employee of the Government of Sri Lanka who is not a citizen of Sri Lanka will not be liable to income tax, in respect of any other sources of income other than;

(i) his official emoluments; and

(ii) his profits and income arising in or derived from Sri Lanka.

(b) **An individual employed in a Sri Lanka Ship.** S. 67(6).

An employee of a Sri Lanka ship within the meaning of the Merchant Shipping Act No. 52 of 1971, will be deemed to be resident of Sri Lanka for the purposes of his liability to income tax during the period of such employment.

Where such employee is not a citizen of Sri Lanka, he will be liable only in respect of his employment income in a Sri Lanka ship.

3. **Non-citizen employed in Sri Lanka.** S. 67(7).[1]

An individual who is not a citizen of Sri Lanka and who is employed in Sri Lanka is deemed to be non-resident for a period of three years from the date on which he commenced employment in Sri Lanka. S. 67(7). The period of three years can be either one stretch of three years or in broken periods aggregating three years.

A non-citizen employed in Sri Lanka, by reason of his being deemed non-resident for a period of three years, will be liable to income tax on his profits and income arising in or derived from Sri Lanka during this period; and his profits and income outside Sri Lanka will not be liable to income tax.

However, non-citizen employees who have already been granted exemption under the earlier provisions before 15th November, 1979, will continue to be exempt from income tax. Non-citizen employees in the Greater Colombo Economic Commission will continue to be exempted from income tax.

1 24 of 1980

Chapter 3

RESIDENT INDIVIDUAL

An individual who is usually domiciled in Sri Lanka would generally be considered a resident individual for tax purposes. An individual's arrival in or departure from Sri Lanka would require an examination of the period of his presence or absence from Sri Lanka to determine whether he is resident or non-resident for purpose of taxation. The basis of determination of residence of an individual for tax purposes is discussed in Chapter 2.

1. Basis of Liability

An individual who is deemed to be a resident individual is chargeable with income tax on his profits and income wherever arising during an year of assessment. S. 2(1)(a). He will thus be liable to income tax on all his profits and income from sources in Sri Lanka and from sources outside Sri Lanka. A resident individual is also liable to wealth tax on the value of all property owned by him other than the value of immovable property situated outside Sri Lanka. S. 54(1)(a). He is also liable to gifts tax on the value of all taxable gifts made by him in an year of assessment other than gift of immovable property outside Sri Lanka. S. 54(1)(a).

2. Liability of Members of the Family of a Resident Individual

A husband and wife are treated for tax purposes as separate individuals and are individually chargeable with income tax, wealth tax and gifts tax and are liable to account for their tax liabilities separately. In computing their individual tax liabilities they are entitled to deduct a tax free allowance of Rs. 12,000 each and permitted deduction in respect of any qualifying payments made by them individually.

The statutory income or the wealth of a child of a resident individual is aggregated with and deemed to form part of the total statutory income or wealth of the father, where the marriage of the parents subsists. Where the marriage of the parents does not subsist the statutory income or wealth of a child is aggregated with and is deemed to be the statutory income or part of the wealth of the parent who maintains the child and with whom the child lives during the year of assessment. S. 46.

3. Exemption of emoluments earned in foreign currency outside Sri Lanka by resident individuals: S. 15(c).

Emoluments earned in foreign currency for services rendered in the course of any employment, profession or vocation carried on or exercised by him is exempt from income tax, if such emoluments after deducting reasonable personal expense are remitted by him to Sri Lanka. S. 9(k) and S. 15(c.).

This exemption applies to individuals who are deemed resident of Sri Lanka and exercise any employment, profession or vocation while out of Sri Lanka for a short period during the subsistence of their resident status. Since a resident individual is chargeable with income tax on his emoluments earned abroad, this exemption provides relief in respect of their emoluments earned abroad while they retain their status as a resident individual. The rules for determining whether an individual is resident or non-resident of Sri Lanka is discussed in Chapter 2.

4. **Exemption of profits and income less than Rs. 1200 from all other sources of income of an individual in receipt of only employment income less than Rs. 30,000.**

Profits and income aggregating to less than Rs. 1,200 for an year of assessment from sources of other than employment received by an individual or any child whose statutory income is aggregated with the statutory income of that individual is exempt from income tax if the total statutory income of that individual consists only of:

(a) employment income less than Rs. 30,000; and
(b) income from other sources less than Rs. 1,200.

5. **Assessable income of a Resident Individual**

The assessable income of a resident individual is his total statutory income for that year of assessment after deducting sums payable in respect of the following: S. 29.

(a) Interest
(b) Annuity
(c) Ground Rent
(d) Royalty
(e) Losses

where the total of the deductions in respect of these exceed the amount of the statutory income such excess can be carried forward and set off against the statutory income of the next succeeding year of assessment and so on till such excess is fully set off. S. 29(2)(a)(ii).

6. **Taxable income of a Resident Individual**

The taxable income of a resident individual is arrived at by deducting from his assessable income;

(a) An allowance of Rs. 12,000; and
(b) Any qualifying payment made by him in that year of assessme

The amount and qualifying payments in respect of which deductions from the assessable income of a resident individual is permitted are discussed in Chapter 33. The residue of the assessable income after deduction of personal allowances and the permitted qualifying payments will suffer tax at prescribed rates of tax applicable for the year of assessment.

7. The Rate of Income Tax

The rates at which a resident individual is chargeable with income tax on his taxable income for the year of assessment 1982/83[1] and subsequent years are as follows:

	Tax slabs	%
On the first	4,800	7½
On the next	4,800	10
On the next	4,800	15
,, ,,	4,800	20
,, ,,	4,800	25
,, ,,	4,800	30
,, ,,	4,800	35
,, ,,	4,800	40
,, ,,	7,200	45
,,	7,200	50
On the balance taxable income ...		55

The rate of tax applies for the year of assessment 1980/81 and subsequent years, unless changes in the rates are made in the future.

Example:

Mr. Perera and his family had the following income for year ended 31.03.1982 and wealth as at April 01, 1981.

	Father Mr. Perera	Mother Mrs. Perera	Son Master Perera
Salary from XYZ Ltd	—	25,000	8,000
Dividends from ABC Ltd (Gross) (tax credit Rs 240)	—	1,200	—
Interest on Fixed Deposit Bank of Ceylon	22,000	—	—
Profits from Business	20,000		
	42,000	26,200	8,000
Wealth as at April 01, 1981			
Business Property	200,000	—	—
Residential House	—	300,000	—
Fixed Deposit, Bank of Ceylon ...	100,000	—	—
	Rs. 300,000	Rs. 300,000	—

Mr. Perera owed Rs. 10,000 on Mortgage Bond bearing interest at 18 % per annum.

Mr. Perera transferred the fixed deposit in his name in favour of his son on April 30, 1981. Mr. Perera paid during the year ended March 31, 1982 premia on his life insurance policy amounting to Rs. 3,000. Mr. Perera and his family are living together at the residential house owned by Mrs. Perera. Master Perera aged 17 is employed in XYZ Ltd. Mr. Perera did not make any taxable gifts prior to April 30, 1981. PAYE tax amounting to Rs. 1,200 had been deducted from Mrs. Perera's salary.

1 24 of 1980.

Computation of tax liability of Mr. Perera — Year of Assessment 1981/82

Income Tax.

						Rs.
Profit from Business ...	...				...	20,000
Interest ...	...				...	22,000
Employment – Master Perera ...	...				...	8,000
Statutory Income	...				Rs.	50,000
Less: Interest paid on Mortgage Bond	...				...	1,800
						48,200
Less: Personal Allowance ...	...			12,000		
Qualifying payment – Insurance premia	...			3,000		15,000
Taxable Income	...				Rs.	33,200
Tax Payable –	4,800	@	$7\frac{1}{2}$ %	360		
	4,800	@	10 %	480		
	4,800	@	15 %	720		
	4,800	@	20 %	960		
	4,800	@	25 %	1,200		
	4,800	@	30 %	1,440		
	4,400	@	35 %	1,540		
Income Tax Payable ...	...				...	6,700

Wealth Tax:

Value of Business property ...	...	200,000	
Fixed Deposit, Bank of Ceylon		100 000	
Total Wealth ...	...	300,000	
Less: Mortgage loan ...	...	10 000	
Net Wealth ...	...	290 000	
Less: Exemption ...	...	200,000	
Taxable wealth @ $\frac{1}{2}$ % ...	...	90 000	450

Gifts Tax:

Taxable Gifts	...		100,000	
Gifts tax payable – ...	50,000		*Nil*	
	50,000	5 %	2,500	2,500

Total Income Tax, Wealth Tax and Gifts Tax Payable ...	Rs.	9,650

Computation of Mrs. Perera's Tax Liability:

Income Tax:

Employment Dividend	...	1,200	Rs.	25,000
Less: Exemption (S. 9(1) *(l)*		1,200		*Nil*
Statutory Income	...		...	25,000
Less: Deductions from Statutory Income	...		...	*Nil*
Assessable Income	...		...	25,000
Less: Personal Allowance	...	12,000		
Provident Fund Contribution ...	...	1,000		13,000
Taxable Income	...		...	12 000

Tax Payable:	4,800	@	$7\frac{1}{2}$ %	360	
	4,800	@	10 %	480	
	2,400	@	15 %	360	1,200
Less: Tax deducted under PAYE:	...		...	1,200	
Tax credit on dividends ...	...		...	240	1,440
Tax repayable ...	...		...	*Rs.*	240

Mrs. Perera is entitled to a refund of income tax paid in excess. A claim for refund must be made before 31.03.1985, since any claim for refund made after three years of the end of an year of assessment is prescribed.

Computation of wealth tax liability of Mrs. Perera:

Value of Residential House: ...	...	*Rs.* 300,000
Less: Exemption from wealth tax on one residence	...	*Rs.* 300,000
Taxable Wealth	... ...	*Nil*

Mrs. Perera is not liable to wealth tax.

8. Payment of Tax:

The tax payable for an year of assessment is payable in four quarterly instalments. The timing of the payments and penalties due on failure to pay the quarterly instalments are discussed in chapter 26.

Each individual is required to calculate the tax and make the payment to the appropriate bank. No assessment will be issued by the Inland Revenue unless the individual has paid less than the amount due as tax or has understated his income, wealth or gifts. In the case of individuals who received emoluments less than Rs. 30,000 for any year of assessment the PAYE is the final tax and is not normally required to furnish a return of income.

Chapter 4

NON-RESIDENT INDIVIDUAL

An individual is considered a non-resident individual for tax purposes on the basis of his presence in or absence from Sri Lanka. An individual who arrives in Sri Lanka and whose stay during the year commencing from the date of his arrival to the date of his last departure does not exceed six months, will be deemed to be a non-resident individual. In the case of an individual who was deemed resident in Sri Lanka for twenty four consecutive months is absent from Sri Lanka for an unbroken period of twelve months will be deemed non-resident from the date of his departure. Basis of determining the residence of an individual is discussed in Chapter 2.

1. Basis of liability

A non-resident individual is chargeable with income tax on the profits and income arising in or derived from Sri Lanka. S. 2(1). Profits and income derived from Sri Lanka include all profits and income derived from services rendered in Sri Lanka or from property in Sri Lanka or from business transacted in Sri Lanka whether directly or through an agent. S. 2(2).

The liability to wealth tax of a non-resident individual is on the value of all property in Sri Lanka. He will not be liable to wealth tax on the immovable or movable property owned by him outside Sri Lanka.

A non-resident individual will be liable to gifts tax on taxable gifts of his movable or immovable property in Sri Lanka. He will not be liable to gifts tax on gifts of movable or immovable property outside Sri Lanka. S. 54(1)(a) & (b).

A non-resident individual who is not a Citizen of Sri Lanka and who is employed in Sri Lanka is deemed to be a non-resident individual for a period of three years from the date of commencement of his employment in Sri Lanka. Such employee by reason of his being deemed non-resident will be liable to income tax on profits and income arising in or derived from Sri Lanka. S. 67(7).[1]

2. Exemption of certain income from liability to income tax of non-resident Individuals.

A non-resident individual is not chargeable with income tax in respect of the following:

---

1. 24 of 1980.

(a) **Profits less than Rs. 1,000 from services rendered or business transacted in Sri Lanka**

Where the assessable income for any year of assessment of a non-resident individual consists solely of profits or income from services rendered in Sri Lanka or from business transacted in Sri Lanka and does not exceed Rs. 1,000 is exempt from income tax. S. 73(1).

(b) **Profits less than Rs. 1,200 of an individual receiving only income from employment less than Rs. 30,000.** S. 9(1).

Profits and income not exceeding in the aggregate of Rs. 1,200 from all sources other than from any employment received by a non-resident individual is exempt from income tax where the statutory income of that individual consists only of;

(i) income from employment less than Rs. 30,000; and

(ii) Profits and income from all other sources less than Rs. 1,200.

(c) **Non-Citizen employed in Sri Lanka**- S. 73(1A).[1]

The assessable income of an individual who is not a citizen of Sri Lanka and is regarded as non-resident individual for purpose of taxation for an aggregate period of three years from the date of commencement of his employment is exempt from income tax where his assessable income consists solely of income from services rendered in Sri Lanka and does not exceed Rs. 12,000: S. 73(1A). This exemption will apply for any year of assessment commencing on or after April 1, 1980.

(d) **Exemption of Certain Profits and Income of Non-resident Individual**

Following income received by a non-resident individual is not liable to income tax unless such profits or income is received in the course of any trade or business;

(i) Any sum received as dividend from a non-resident company. S. 73(2).

(ii) Any sum received as interest, annuity, ground rent or royalty which is payable to him by any person out of Sri Lanka. S. 73(2).

(iii) Profits and income arising from any Treasury Bills. S. 73(3).

Where any of these sums form part of the receipt of any trade or business carried on in Sri Lanka, such sums will be included in the computation of profits or income of such trade and will be liable to income tax. S. 73(4).

3. Rate of Income Tax payable by a non-resident individual on royalites received from a company in the Investment Promotion Zone

The rate at which income tax is payable on royalties received by a non-resident individual from any company with which an agreement has been entered into by the Greater Colombo Area Economic Commission will not exceed the rate specified in that agreement. S. 73(5).

1. 40 of 1981

4. Profits of a non-resident person from employment

Profits of a non-resident person from employment by a resident person will include all such profits from services or past services rendered in Sri Lanka. S. 72. Pension received by a non-resident individual will be liable to income tax.

5. Liability of the members of the family of a non-resident Individual

The assessable income or wealth of the wife or child of a non-resident individual is not aggregated with the income or wealth of the husband or father. Each member of the family of the non-resident individual will be liable individually to income tax, wealth tax or Gifts tax.

6. The assessable income of a non-resident individual

The assessable income of a non-resident individual is the total statutory income for that year of assessment after deducting sums payable in respect of the following;

- (a) Interest;
- (b) Ground rent;
- (c) Annuity
- (d) Royalty;
- (e) Losses;

Where the total deduction from the statutory income exceed the statutory income, such excess can be carried forward and set off in the next succeeding year of assessment and so on.

7. Taxable income of a non-resident individual

The taxable income of a non-resident individual shall be his assessable income after deduction of any qualifying payments made by him. S. 30(2).

Qualifying payments in respect of which a non-resident individual is entitled to deduct is discussed in Chapter 33. A non-resident individual is entitled to claim allowance in respect of any qualifying payments to which any individual is entitled to deduct from his assessable income.

8. Rates of Income Tax

A non-resident individual is liable to income tax at the same rates of income tax, wealth tax or gifts tax applicable to a resident individual.

A concessionary rate of tax at 25% applies to a non-citizen employee who is not a citizen of Sri Lanka: Third Schedule – Part III. Such concessionary rate will apply for the period of three years from the date of commencement of employment of such non-citizen employee.

9. Marginal Relief from income tax in respect of non-citizen employee who is non-resident individual

Tax payable by a non-citizen employee who is deemed to be non-resident shall not be more than the amount by which his assessable income exceeds Rs. 12,000. S. 32(1)(c)[1]. Relief is provided so that in marginal cases the

1. 24 of 1980, and 40 of 1981

tax payable by such non-resident individual will not reduce his assessable income below Rs. 12,000.

Example:

Tax payable by a non-citizen employee whose assessable income is Rs. 15,000 @ 25 % is Rs. 3,750. In this case the income after tax is Rs. 11,250 and reduces the assessable income below the exemption limit of Rs. 12,000 The tax payable when relief is provided is as follows:

Tax payable Rs. 15,000 @ 25 %	= Rs.	3,750
Marginal relief Rs. (12,000—(15,000—3,750)	=	750
Tax payable	= Rs.	3,000

Such an adjustment provides relief in that the tax payable does not reduce the assessable income below Rs. 12,000. Where tax payable does not reduce the assessable income below Rs. 12,000 no relief is due and full amount of the tax is payable.

Chapter 5

HUSBAND, WIFE AND CHILD

A husband and wife in a family are treated as separate individuals and are liable to income tax, wealth tax or gifts tax on their income, wealth or gifts and are liable to account for their tax liability individually. They are also required to furnish a return of income, wealth or gifts and pay their tax under self assessment.

The statutory income or wealth of a child of a resident individual is aggregated with the statutory income or wealth of the father during the subsistence of the marriage of his parents. Where the marriage of the parents does not subsist, the statutory income or wealth of the child is aggregated with the statutory income or wealth of the parent who maintains that child and with whom the child lives in that year of assessment.

1. Partnership of Husband and Wife in exercising or carrying on a trade, business, profession or vocation.

Where a husband and wife carry on a trade, business, profession or vocation in partnership they will be individually liable to income tax on their share of the divisible profits from the partnership. In order to be able to divide profits of a partnership between a husband and wife, it must be established that the husband and wife carried on that trade, business, profession or vocation in common with a view to profits. All relevant evidence of the existence of a partnership between the husband and wife should be present to establish of such partnership.

2. Payments made by one spouse to another for services rendered.

Where one spouse is carrying on or exercising any trade, business, profession or vocation and makes any payment to the other spouse for services rendered such payment is deemed to be profits and income of the spouse making the payment. S. 23(6). Thus, where a husband carries on a trade, business, profession or vocation and makes any payment for services rendered to his wife such payment is deemed to be the profits and income of the husband. Therefore, in computing the profits for tax purposes from the trade, business, profession or vocation carried on or exercised by the husband, payments made to the wife for services rendered should be added to the profits of that trade, business, profession or vocation in computing income tax liability of the husband.

3. **Payments made by a Partnership to a spouse of a Partner for services rendered**

Payment made by a partnership to the spouse of a partner for services rendered is deemed to be the profits of such partner. S. 23(6). Thus where the husband is a partner of a partnership carrying on a trade, business, profession or vocation and payments are made by that partnership to his wife for services rendered by her such payments will be deemed to be his profits and income. Therefore, in computing the share of the adjusted divisible profits, of such partner, payments made to his wife for services rendered must be added to his share of the divisible profits of the partnership.

4. **Definition of child.** S. 163

A child in relation to an individual means a child who is –

(a) Under eighteen years of age,

(b) A child adopted under the Adoption of Children Ordinance by that individual and where that individual is not a citizen of Sri Lanka, a child adopted under the law of the country of which he is a subject or citizen.

The definition of child does not cover the following –

(a) A child over eighteen years of age;

(b) A married child;

(c) An illegitimate child;

(d) Any child adopted under any other law.

5. **Aggregation of the Statutory Income or Wealth of a child.** S. 28 and S. 48

The Statutory income or wealth of a child is aggregated with and is deemed to form part of the statutory income or wealth of the parent. The parent who is chargeable with income tax or wealth tax on the income or wealth of a child depends on whether or not the marriage of the parents subsists and is determined as follows:–

(a) **Where the marriage of the parents subsists**

Where the marriage of the parent of a child subsists the total statutory income or wealth of a resident individual is aggregated with and is deemed to form part of the total statutory income or wealth of his father in that year of assessment. S. 28(a) and S. 46(b).

(b) **Where the marriage of the parents does not subsist**

Where the marriage of the parents does not subsist, the total statutory income or wealth of a child of a resident individual is aggregated with and is deemed to form part of the total statutory income or wealth of the parent who maintains him and with whom he lives in that year of assessment. S. 28(b) and S. 46(b).

6. **When a marriage is deemed not to subsist**

A marriage is deemed not to subsist if:–

(a) The wife is living apart from her husband under the decree of a competent court or duly executed deed of separation; or

(b) If the husband and wife are in fact separated in such circumstances that the separation is likely to be permanent. S. 28.

7. **Deductions from the statutory Income of a child where his income is aggregated with that of his parent**

Where the total statutory income of a child is aggregated with and is deemed to form part of the statutory income of his parent, for any year of assessment, any deductions to which such child is entitled to deduct from the total statutory income of such child can be deducted from the total statutory income of the parent. Sums which can be deducted are: S. 29(10).

(a) Any sum payable by a child as annuity, ground rent, royalty or interest.

(b) Any losses incurred by that child.

8. **Deductions from the assessable income of the parent in respect of qualifying payments of a child.** S. 31(4).

Where the total statutory income of any child for any year of assessment is aggregated with and is deemed to be part of the total statutory income of his parent, any qualifying payment made by that child in that year of assessment is deemed to be a qualifying payment made by such parent. S. 31(4).

The amount of the deduction in respect of qualifying payments of a child and a parent that can be deducted is based on the assessable income of the parent. The assessable income of the parent is the total of the statutory income of the child and the parent after deducting amounts which the child and the parent are entitled to deduct from their statutory incomes. S. 29(10).

9. **Deductions from wealth of a child where such wealth is aggregated with his parent.** S. 47(2).

Where the wealth of a child for any year of assessment is aggregated with and deemed to form part of the wealth of his parent, any deduction from wealth to which such child is entitled to deduct is deducted from the wealth of his parent.

10. **Assessment of a child's income or wealth in the year of assessment in which he reaches the age of eighteen years or marries.** S. 59(1).

Where a child reaches the age of eighteen years or marries during any year of assessment, such child will be liable to income tax and wealth tax for that year of assessment as though he was an individual who is not a child throughout that year of assessment. For example, where a child reaches eighteen years of age or marries on October 01, 1982, he will be regarded as an individual throughout the year of assessment 1982/83, that is, the period April 1, 1982 to March 31, 1983 and is liable to pay income tax and wealth tax. No part of the statutory income of that child for the period April 1, 1982 to 30th September 1982 will be aggregated with the statutory income of his parent. S. 59(1)(a). Any deductions to which such child is entitled to deduct from his statutory income in respect of any annuity, ground rent, royalty or losses in that year of assessment will be deducted from the statutory income of that individual and no deduction in respect of such sums can be made from the statutory income of the parent. S. 59(1)(b). Any qualifying payment made by such individual during that year of assessment will qualify for deduction against the assessable income of that individual and will not be aggregated with and deemed to be a qualifying payment of his parent. S. 59(1)(c).

The wealth of the child on April 01, of the year of assessment in which he reaches eighteen years of age or marries is chargeable with wealth tax on that child and is not deemed to form part of the wealth of his parent S. 59(1)(d). The child would be entitled to deduct any deductions to which he is entitled to from his wealth in arriving at his net wealth. No deductions in respect of such sums can be made from the wealth of his parent in that year of assessment. S. 59(1)(e).

11. Assessment of the child's income or wealth in the year of assessment in which the marriage of the parents ceases or is not deemed to subsist. S. 59(2).

Where during an year of assessment the marriage of the parents of a child ceases or is deemed not to subsist the statutory income or wealth of that child for that year of assessment is aggregated with and deemed to be part of the total statutory income or wealth of his father, S. 59(2)(a). For example, where the marriage of the parents ceases to subsist on October 1, 1982, the statutory income for the period April 01, 1982 to March 31, 1983 and wealth as at April 01, 1982 will be aggregated with the statutory income and wealth of his father for the year of assessment 1982/1983.

Any deductions in respect of annuity, ground rent, royalty, interest or losses which a child is entitled to deduct from his statutory income can be deducted from the total statutory income of his father. S. 59(2)(b). Any qualifying payment made by that child in that year of assessment is deemed to be a qualifying payment made by the father. S. 59(2)(c).

The wealth of the child as at April 01, in the year of assessment in which the marriage ceases or is deemed not to subsist is aggregated with and deemed to form part of the wealth of the father. S. 59(2)(d). Any deductions from wealth to which such child is entitled to can be deducted from the wealth of his father. S. 59(2)(e).

12. Recovery of income tax and wealth tax from the child. S.134.

Where the statutory income or wealth is aggregated with the statutory income or wealth of the parent, such parent is liable to pay the income tax or wealth tax on such income or wealth. Where the income tax or wealth tax cannot be recovered from that parent such part of the income or wealth tax attributable to the income or wealth of such child can be recovered from that child notwithstanding that no assessment has been made on such child.

Example:

The statutory income and wealth of Mr. Perera and his son Master Perera aged 16 for the year of assessment 1982/83 is as follows:

Statutory Income

Mr. Perera:

Profits from trade	...	...	Rs. 20,000
Interest on Mortgage	...	...	Rs. 5,000
			Rs. 25,000

Master Perera:

Interest on Fixed Deposit	...	...	Rs. 8,400

Wealth as at April 01, 1982:

Mr. Perera:

Value of Business Property	...	...	Rs. 200,000
Money given on Mortgage	...	...	Rs. 50,000
			Rs. 250,000

Master Perera:

Fixed Deposit with People's Bank	...	Rs. 60,000

Computation of Tax Liability: Mr. Perera:

Income Tax:

	Trade Profits	...	...	Rs. 20,000	
	Interest	...	...	Rs. 13,400	
	Total statutory Income	...	...	Rs. 33,400	
Less:	Personal allowance	...	...	Rs. 12,000	
	Taxable Income ...	...	...	Rs. 21,400	
	Taxed: 4,800 – $7\frac{1}{2}$ % 360				
	4,800 – 10 % 480				
	4,800 – 15 % 720				
	4,800 – 20 % 960				
	2,200 – 25 % 550				
	Income Tax Payable	...	...	...	3,070

Wealth Tax

	Business Property	...	...	Rs. 200,000	
	Fixed Deposit, People's Bank	...	...	Rs. 60,000	
	Money given on Mortgage	...	...	Rs. 50,000	
				310,000	
Less:	Exemption	...	...	200,000	
	Taxable Wealth ...	...	...	110,000 @ $\frac{1}{2}$ %	550
	Total income tax and wealth tax payable	...	...		Rs. 3,620

Where the income tax and wealth tax cannot be recovered from Mr. Perera, the income tax or wealth tax attributable to his son Master Perera can be recovered from Master Perera, although no assessment has been made on him. The tax attributable to Master Perera is calculated as follows:

Income Tax $\frac{8{,}400}{33{,}400} \times 3{,}070 = 772$

Wealth Tax $\frac{60{,}000}{310{,}000} \times 550 = 106$

Total of income tax and wealth tax attributable to Master Perera ... ... Rs. 878

Chapter 6

COMPANIES

A Company is a form of business organisation recognised in law as a legal person, maintains a separate identity of its own from that of the owners, the shareholders. A company under the Inland Revenue Act means a company incorporated or registered under any law in force in Sri Lanka or elsewhere and includes a Public Corporation: S. 163. For the purposes of imposition of tax liability Public Corporations are considered as Companies. The subject matter discussed in this chapter covers companies incorporated under the Companies Act.

1. Basic Principle of Liability

A Company can be incorporated by any seven or more persons, or where, the company to be formed is a private company, any two or more persons, associated for any lawful purpose, may by subscribing their names to a memorandum of association and otherwise complying with the requirements of the company law in respect of registration, form an incorporated company with or without limited liability. Such a company will operate within the framework of the memorandum and articles of association and the shareholders have no hand in the management and control although the ownership is vested with the shareholders.

Apart from the principle of separate identity of the company with that of the shareholders there is legal provision which brings into liability to tax the profits and income of a company from transactions with its shareholders: S. 36. It is settled law that if the persons carrying on a trade do so in a way that they and the customers are the same persons, no profits or gains are yielded by the trade for tax purposes on the general principle that a person cannot make profit out of himself. However, a company can make profits out of its members as customers, although its range of customers are limited to its shareholders as the profit belongs to them as shareholders and not as purchasers or customers: *Jones v. The South West Lancashire Coal Owners' Association Ltd.* 11 TC 814. This important principle of recognising the separate identity of the company and the shareholders is the main basic principle on which the company taxation is built up.

2. Companies v. Proprietorship.

The relative attractiveness taxwise of a company or a proprietorship depends on the size and regularity of the income of the company and the size of other income of the shareholders and the extent to which the business income can be retained by the company. Regardless of the size of the business income or of their other income a corporate form of business organisation is clearly disadvantageous unless the entire withdrawal can be made in the form of salary or other deductible expenditure. However, in respect of remuneration to the Directors, such amounts should be commercially justifiable and should relate to the services received so as to be a deduction claimable as an outgoing incurred in the production of income. Double taxation will clearly and obviously operate in cases of full annual distribution of profits to the shareholders.

3. **Dividends and Reserve.**

The separate taxation of dividends in the hands of the shareholders will generally tend to discourage distribution of dividends and encourage the building up of reserves and ploughing back of profits. In such a situation, the retention of profits will in all circumstances, be reflected in the value of the shares and transfer of this could be made with a minimum of liability, at the capital gains tax rate on the disposal of the holdings. The shareholders could ultimately realise the benefit of the retained profits either by selling their shares or on a capital reduction or on liquidation, but they would receive it as tax free capital and not as taxable income – the least being capital gains tax liability. A bonus issue, repayment of capital by capital reduction with the approval of the court does not generally amount to distribution of profits and can be passed to the shareholders without attracting tax liability. The relationship between retained profits and the value of the shares is more direct in the case of small companies than in the case of quoted companies with numerous shareholders, but exists to some extent for all companies however large or small.

4. **Public Companies.**

The term public company is synonymous with the diffusion of the ownership in a large number of shareholders, whose relationship with the company and the rights and obligations are defined in the company law. In the case of public company the dichotomy of management and the ownership effectively maintains its separate identity. The shareholders have little to do with the management or the dividend policy, and the entrepreneur naturally enough, as his continued existence in affluence and power depends on the maintenance and improvement of the company's earning capacity, has a vested interest in the reserves so long as he can keep the shareholders satisfied with a minimum distribution. The management is vested with the board of directors reflected by the shareholders and has defined areas of activities in terms of the memorandum and articles of association. This is the best form of organisation in ventures where there is high degree of risk and the channelling of small savings, into a corporate body to enable such a body to undertake ventures in those fields in which private individual investment is not possible. In the case of these public companies the interest of the shareholders and market price of shares will generally to a great extent reflect the attitude of the directors and managements on their dividend policy.

The Government policy actively encourages the formation of corporate form of business and the Finance Minister has outlined the Government policy –

"......While we concentrate on investment and growth, the government is equally conscious of the need to ensure that the fruits of this increased prosperity are shared by as large a number of people as possible...... The company form of business organisation should be actively encouraged to attract the small investor into its fold. To achieve this end, not only should investment in equity share capital be made more attractive through the prospect of better yields, but the tax concessions to companies should be geared to induce corporate business to become more broad-based. Fiscal policy should be designed to reactivate the capital market which is a valuable adjunct of the financial system in ensuring the flow of funds for investment"......

Budget Speech 1980.

A package of incentives are provided through the concept of –

(a) A small company;
(b) A Peoples Company;
(c) A Quoted Public Company.

The incentives provided are:

(a) Concessionary rate of tax;
(b) Distribution of dividends gross without tax deduction;
(c) Exemption of capital gains on the transfer of shares;
(d) Exemption of capital gains on the conversion of a Proprietorship or Partnership into a quoted public company.

5. **Private Companies**

A private company is a company which –

(a) restricts the right to transfer its shares;
(b) limits the number of its members to fifty;
(c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

In these companies the ownership is generally limited to a few shareholders who are invariably the directors and there is restriction on the transfer of shares to persons other than the persons who constitute the company as shareholders. These are generally family concerns usually formed to take advantage of certain facilities which accrue to such companies. In such companies, where the shareholders have high income and their individual rate of tax is high, there will be a strong disinclination to declare dividends. When these companies are controlled by few persons who have a controlling interest, then the inclination to declare dividends will depend on the individual tax rate; if it is high it will provide no inducement to declare dividends. The decision to accumulate profits or to declare dividends will be governed by the possible advantage that comes from spreading the distribution over time avoiding large payments in a single year, thereby reducing the progressive effect of the individual income tax.

A departure from the company taxation is the separate treatment of companies controlled by not more than five persons. This treatment applies to family concerns which might manipulate the company so as to obtain fiscal benefits for themselves; but in many cases, the provisions of section 39 can be severe in its operation as it actually imposes severe fiscal penalties.

Accordingly, in the companies in which more than half the total shares issued is held by not more than five persons, their wives or minor children, either directly or through nominees, an Assessor is empowered to deem part or whole of the profits of a relevant year which the company could have reasonably distributed as distributed to its sharesholders. S. 39.

6. **Determination of Profits and Income of a Company.**

There is no separate distinction or treatment in determining the profits and income from any source of a company. The computation of profits and income from any source is made in accordance with the general provisions of the Inland Revenue Act and practice relating thereto. The amount of the income, when it is deemed to arise and the expenditure allowed in respect thereof is determined accordingly.

The company is entirely separate from the individuals who own it, so the distinction between business expenses and personal consumption does not arise. Thus dividends declared and paid to shareholders is treated as distribution and any interest paid to a shareholder is treated as a deductible expenditure.

In the case of companies controlled by a few shareholders, it is possible to withdraw profits in the form of deductible expenses, such payments can be in the form of remuneration, interest, rent, royalties etc., which will qualify for deduction and expenses incurred in the production of income. However, in respect of remuneration to directors, the expenditure charged must be commercially realistic and must relate to the services received in return.

> "It may very well be that there are sums which are paid to the directors as remuneration for their services in accordance with the articles of association and in accordance with a resolution of the company, but it does not necessarily follow in the least that they are sums which are wholly and exclusively laid out for the purposes of the trade"......... Lawrence J. in *Copeman v. William Flood & Sons Ltd.* 24 TC 53.

Although the words 'wholly and exclusively laid out for the purposes of the trade' are not synonymous with the words 'incurred in the production of income' the Revenue may invoke the rule that the remuneration paid must be commercially realistic.

In the case of Investment Companies, the income derived from dividends and interest fall within the words 'profits and income', as the company is carrying on business as per its memorandum of association. Accordingly, the management expenses of the company is deductible as outgoings and expenses incurred in the production of income in ascertaining the profits of the company from these sources. *(Ceylon Financial Investment Co. Ltd. v. C.I.T.* 1 CTC 206)

Management fees and other charges reflect payment for services rendered and would qualify for deduction as outgoings and expenses in earning profits of a company receiving such services. These charges, however, must be levied on a consistent basis and must relate to the value of goods and services supplied. Where excessive charges are made in one accounting period and a correspondingly reduced charges are made in later periods may result in some dissallowance by the Revenue *(Stephensin v. Payne, Stone, Fraser & Co.* 44 TC 507).

7. Group Companies.

The principle of separate identity is maintained and the parent company and the subsidiary are taxed separately on their own income. There may be compelling commercial reasons which make it convenient for separate aspects of a business to be split up between several companies. Certain disadvantages are likely to result as it will not be possible to claim deduction of certain losses.

A common problem is that where a new division of the business is carried on within the group it is set up in a corporate form of business for geographical reasons. Under such an arrangement, the investment in a branch by way of trading stock or trade debtors or establishment expenses is merged in the trading results of the company as a whole but when these items are financed out of capital subscribed or lent to a separate company it is likely that the parent company will be unable to obtain tax relief for the loss.

In the case of *English Crown Speltor Co., Ltd. v. Baker:* 5 TC 327, where mining operations were initiated through a Welsh subsidiary which was chronically short of cash it's difficulties were alleviated by advances from the parent company against parcels of ore to be delivered. When failure of the venture became apparent no relief from tax was obtainable since the advances were not trading outlay but the employment of capital.

A company which advanced to another company in order to secure supplies of raw material, was held to be an advance in the nature of a loan or capital expenditure and not deductible: *Charles Marsden & Sons Ltd. v. C.I.R.* 12 TC 217.

In the case of *Oldhams Press Ltd. v. Cook:* 23 TC 233, a credit passed to a loss making subsidiary in order to cancel a charge for trade services was disallowed. The company claimed to deduct loss made on the operations of a subsidiary in which it held all the shares, and for which it did printing work at ordinary prices. It was argued for the company that the parent company was obliged to preserve its credit rating.

8. Basis of Liability.

A Company is liable, as in the case of every other person, to income tax on the profits and income of the year of assessment. The company must keep accounts, as in the case of every other person, to a period ending on the 31st of March each year, unless the Commissioner General of Inland Revenue has in his discretion allowed such company to maintain accounts to a date other than 31st of March.

A Company RESIDENT in Sri Lanka is assessable on the profits and income wherever arising, i.e. on its world income. A NON-RESIDENT Company is liable on the profits and income arising in or derived from Sri Lanka. S. 2. Profits and income arising in or derived from Sri Lanka of a non-resident company include any profits and income derived from services rendered in Sri Lanka, or from property in Sri Lanka or from business transacted in Sri Lanka, whether directly or through an agent. S. 2(2).

A non-resident company will come within the charge of liability if it carries on a trade or business in Sri Lanka through a branch or an agent. The fundamental distinction between trading 'with' and trading 'within' Sri Lanka must be drawn to determine whether the non-resident company is carrying or trade or business in Sri Lanka.

9. Residence of a Company

A company is deemed to be resident in Sri Lanka where the company has its registered or principal office in Sri Lanka or where the control and management of its business are exercised in Sri Lanka: S. 67(1). The question whether a company is resident or non-resident is always a question of fact, to be determined upon the scrutiny of the course of business and trading and each case must turn upon its particular circumstances.

> "A company resides for income tax purposes where its real business is carried on ...... the real business is carried on where the central management and control actually abides" ...... (*De Beers Consolidated Mines Ltd. v. Howe:* 5 TC 198). The management and control abides in the place from which the ultimate control may be exercised, is to say the place where those persons, in whose hands that control lies, meet for the purpose of exercising that control. This control must be exercised by the directors in board meeting and not the control as is exercised in a general meeting for it is not the legal corporators who are carrying on the business": *Kodak Ltd. v. Clark:* 4 TC 549.

The domicile of a company must be distinguised from residence. The domicile of a company is the place where it was incorporated or registered and the domicile adheres to the company throughout its existence. The test of residence on the other hand is not registration but the place where the company does its business, i.e. the place of its management and control.

> "Nothing can be more factual and concrete than the acts of management which enable a Court to find as a fact that central management and control is exercised in one country or another".
>
> Viscount Simonds in *Unit Construction Co. v. Bullock:* 38 TC 736.

The place of registration or incorporation is not conclusively its place of residence although it could be a factor in deciding where the control is situated: *Egyptian Delta Land and Investment Co. Ltd. v. Todd:* 6 TC 152. A limited liability company can contemporaneously have more than one residence.....central management and control may be divided.

> "A registered company can have more than one residence for purposes of income tax acts ...... The effect of *De Beers* case is that when the central management and control of a company abides in a particular place the company is held for purpose of income tax to have a residence in that place: but it does not follow that it cannot have a residence elsewhere. An individual may clearly have more than one residence...... and on principle there appears to be no reason why a company should not be divided ...... and if so, it may have more than one residence."
>
> Lord Cave in *Swedish Central Rail Co. Ltd. v. Thomson:* 9 TC 373.

10. Companies Registered under the Foreign Companies (Special Provisions) Law No. 9 of 1975

All non-resident companies which had their registered offices outside Sr Lanka were required to register these companies in Sri Lanka under the provisions of this law. The new company registered in Sri Lanka will be allotted shares in the same proportion in which such shareholders held shares in the foreign company immediately prior to such transfer.

In accordance with the principles contained in the *De Beers* decision with regard to the basis of determination of residence, these companies will continue to be non-resident companies unless there is evidence to the contrary as regards the place of management and control.

11. Officers of the Company Answerable to the Revenue.

The Secretary, Manager, Director or other Principal Officer of every company, shall be liable to do all such acts, matters or things as are required to be done to comply with the provisions of the Inland Revenue Act. However, a person to whom a notice is given on behalf of the company shall be deemed to be the principal officer unless he proves that he has no connection with the company and that some other person resident in Sri Lanka is the Principal Officer: S. 146(1).

The company is primarily and solely chargeable and therefore the Principal Officer is not chargeable out of his personal assets with the income tax levied on the Company's assessable income: *M. E. de Silva v. CIT:* 1 CTC 410. The charge to income tax is on the company and not on the Principal Officer.

Any offence committed by the Company under provisions of the Inland Revenue Act is deemed to have been committed by every person who at the time of the commission of that offence was the Secretary, Manager or other Principal Officer of that company and shall be guilty of that offence unless he proves that the offence was committed without his knowledge and that he exercised all such diligence to prevent the commission of that offence as he ought to have exercised having regard to the nature of his functions in such capacity and to all circumstances. S. 146(2).

12. Tax Liability of a Company

A company is liable to income tax on its profits and income computed in accordance with the law and practice prevailing. For the purpose of liability companies have been classified into different categories and are chargeable at specified rates of tax applicable to such companies. The classification falls under the following heads:

1. A Resident Company.
2. A Non-Resident Company.
3. Resident companies are classified further into
    (a) A small Company
    (b) A People's Company
    (c) A Quoted Public Company.

A company is also liable, in addition to a tax on its profits and income to a tax on –

(a) **Dividends**:– Gross dividends distributed by a Resident company which is not a Quoted Public Company in that year of assessment.

(b) **Remittances**:– of a Non-Resident Company in an year of assessment.

13. **Dividends.**

A DIVIDEND is a share of the profits of a company divided among the shareholders. Dividends are proposed or recommended by the Directors and declared by the company in general meeting, the shareholders having usually to pass a resolution sanctioning the proposed distribution.

The term 'Dividend' includes any distribution of profits by the company to its shareholders in the form of – S. 163.

(a) Money or of an order to pay money; or
(b) Shares in any other company; or
(c) debentures in that company or in any other company; and
(d) a return of capital within six years of capitalisation of profits by the issue of bonus shares to the extent of the capitalisation of profits.

A bonus share is not a dividend, as can be seen from the reasoning of Viscount Cave in the case of *C.I.R. v. Blott:* 8 TC 101:

"The transaction took nothing out of the company's coffers and put nothing in the shareholders' pockets: and the only result was that the company which before the resolution could have distributed the profits by way of a dividend, or carried it temporarily to reserve came hence forth under an obligation to retain it permanently as capital. It is true that the shareholder could sell his bonus share, but in that case, he would be realising a capital asset producing income and the proceeds would not be income in his hands ....."

It will therefore, be possible to transfer profits of the company to the shareholders by capitalising the profits and issuing bonus shares without attracting tax liability. Repayment of such shares within six years of capitalisation will attract liability to the extent of the paid up value of such bonus shares. Subject to this limitation, a taxpayer selling the shares and realising the value thereof will attract liability to capital gains tax only, such tax would be less than his liability to income tax had such profits been distributed as dividend. A capital reduction or liquidation may also achieve the same result.

(a) **Dividend received by a Company is not part of its Assessable Income.** S. 35.

A dividend paid by a resident company to another resident or non-resident company shall not form part of the assessable income of the company receiving the dividend, provided that the resident company which paid the dividend:

(i) is a company which is not a quoted public company and has deducted tax at 20 %[1]; or
(ii) declared a dividend which is exempt from income tax; or
(iii) declared a dividend which consists of any part of a dividend received by the company paying the dividend, from another resident company; or
(iv) is a quoted public company.[2]

(b) **Additional Deduction in Respect of Dividend Payable to a Non-resident Company**: S. 37[3]

Every resident company paying a dividend to a non-resident company shall deduct income tax at five percent of the gross amount of

1. 24 of 1980. 2. 24 of 1980. 3. 27 of 1982

the dividend paid. The levy of income tax at five percent on dividends will apply as follows:

(i) Where the dividend declared consists of dividend received from another resident company, not being part of the amount of a dividend exempt from income tax, 5 % of the amount of such dividend increased by twenty five percent.[1] S. 37(a).

Example:

XYZ Ltd. a resident company paid a dividend of Rs. 10,000 to a non-resident company. The entirety of the dividend was paid out of dividend received from another resident company. The amount of the dividend, increased by 25 % in this case is Rs. 12,500 and the tax deductible at 5 % is Rs. 625.

(ii) Where the dividend declared is not exempt from income tax and does not consist of any part of a dividend received from another resident company, 5 % on the gross amount of the dividend paid. S. 37(b).

(iii) Where the dividend is paid out of a dividend received by a resident company which is exempt from income tax, 5 % on the amount of the dividend paid. S. 37(c).

(iv) Where the dividend is paid out of dividend received by a resident company from a quoted public company. 5 % on the amount of the dividend paid. S. 37(d).[2]

Commissioner General may direct a lower rate: S. 37 Proviso.

Where the Commissioner General is satisfied that

(i) the non-resident company is not liable to pay income tax for year of assessment in which the dividend is received ;or

(ii) the non-resident company is liable to pay income tax of an amount lower than the amount of income tax at five percent required to be deducted from the dividend from a resident company:

may direct that income tax at a lower rate than the specified five percent be deducted having regard to the amount of income tax, such non-resident company is liable to pay for that year of assessment.

Tax required to be deducted by Resident Company is a debt due to the Republic

The income tax which a resident company is required to deduct on dividend payable to a non-resident company is a debt due to the Republic and is recoverable forthwith. Such tax may be assessed and charged upon the resident company in addition to any income tax, such resident is liable to pay.

(c) **Dividends paid in the Form of Shares**. S. 38(5).

Any distribution of profits by a company to its shareholders in the form of shares in any other company or debentures in the company or in any other company is a dividend. S. 163. The company other than the Quoted Public Company is liable to tax at 20 % on such dividend.

1. 27 of 1982 and 24 of 1980 2. 27 of 1982 and 24 of 1980.

Where the dividend is not in the form of money or an order to pay money, the company is not entitled to deduct tax at 20%. S. 38(i).

(d) **Obligations of a Company in Respect of Dividends**

When a dividend is paid by a resident company, other than a quoted public company, to its shareholders, the company is entitled to deduct tax equal to twenty percent[1] of such dividend. The company is only entitled to deduct, but is not required to deduct tax under the Act. Where a dividend is declared out of profits which are not liable to income tax, for example, receipts from sales of capital assets, subsidies, amounts allowed as once and for all depreciation, the company need not deduct tax. In such cases, the shareholder will be liable to tax on the amount of the dividend received, but will not be entitled to claim credit to any tax, as no tax has been deducted. The company need not deduct tax in respect of dividends declared out of dividends received from another company. S. 38(1)[2].

A company is required to annex a statement in writing in the following form when a warrant, cheque or other order drawn or made in payment of any dividend: S. 38(2).

(i) the gross amount of the dividend;
(ii) the sum deducted as income tax;
(iii) the net amount actually paid;
(iv) that part of the dividend that is declared out of the dividend received from another company, stating whether the whole or any part of the dividend is exempt from income tax or is received from a quoted public company.[3]

14. **Tax to which a Resident Company is liable.**

A resident company which is not a quoted public company is liable to income tax on the profits and income of the year of assessment consisting of:

(a) A sum equal to 50 % of the taxable income for that year of assessment; and
(b) a sum equal to 20 % of the aggregate amount of the gross dividends distributed by the company out of the profits on which the taxable income is computed for any year of assessment.

The tax on the profits of the company is non-refundable. The tax on dividends is an advance payment of tax paid by the company on behalf of the shareholders. All shareholders other than companies, will be entitled to a set off of the tax deducted against their income tax liability. Where the shareholder is not liable to income tax, he will be entitled to claim a refund of the tax deducted. Where the shareholder is a company the dividend will not form part of the assessable income of the company and cannot claim a set off or a refund in respect of the tax deducted on the dividends. S. 38(4).

The liability to tax of a resident company is worked out in the following manner;

---

1. 24 of 1980. 2. 24 of 1980. 3. 24 of 1980.

Example:

Profits of a resident company for year ended 31/3/82 ...				...	*Rs.* 100,000
Dividend declared out of profits during the year ...				...	*Rs.* 20,000

Tax Payable by the company

Income Tax ...	... *Rs.* 100,000	@	50 %	=	*Rs.* 50,000
Tax on Dividends	... *Rs.* 20,000	@	20 %	=	*Rs.* 4,000
Total liability ...	...	...	...		*Rs.* 54,000

The tax on the dividend, is considered a refundable tax in the sense that although paid by the company, the shareholder is entitled to set off against his tax liability or to a refund where he is not liable to income tax. When the dividend is paid the company is entitled to deduct tax and pay the balance to the shareholder. The dividend paid would be disbursed by the company as follows;

Dividend declared Rs. 20,000 — Rs. 16,000 to shareholders
— Rs. 4,000 to Revenue.

The shareholders receiving the net dividend of Rs. 16,000 will ultimately recoup the tax of Rs. 4,000 either as a set off against their tax liabilities or as a refund of income tax.

A resident company cannot deduct the amount of the dividend paid in computing its profits for purpose of taxation The company will not be liable to income tax on dividends received from another resident company. The dividend received by a resident company from another resident company would have suffered deduction of tax at 20% and is free from income tax in its hands and can declare dividend without having to account for income tax on this.

15. Tax to which a Non-Resident Company is Liable

(a) **Income Tax** S. 34(1)

Income Tax to which a non-resident company is liable consist of,

(i) a tax of 50 % on the taxable income of the company;
(ii) an additional levy of 5 % of the taxable income; and
(iii) a tax of $33\frac{1}{3}$ % of the aggregate amount of its remittance or $11\frac{1}{3}$ % of its taxable income whichever is less.

Remittance Tax of a Non-Resident Company. S. 34(2).

A non-resident company is liable to tax on its remittance made in an year of assessment. The tax on remittance is based on the taxable income of the company in that year of assessment and is applied as follows:

(a) $33\frac{1}{3}$ % of the remittances during the year of assessment where such remittance does not exceed one third of the taxable income; or

(b) $11\frac{1}{3}$% of the taxable income where the remittances exceed one third of the taxable income.

The effect of the remittance tax will make it profitable for a non-resident company to accumulate its profits and remit them in an year in which taxable profits are low. In such cases the tax payable cannot exceed the ceiling of $11\frac{1}{3}$ % of the taxable income of the non-resident company for the year if the remittances are more than the taxable income for that particular year. It would be legitimate for the non-resident companies to defer remittance till the taxable income of a particular year is low and obtain substantial tax relief from the incidence of the remittance tax.

Remittances of a non-resident company include the following:

(a) **Sums remitted or retained out of the profits of that company.** S. 34(2)(a).[1]

The amount of the remittance made during the year of assessment will be taken into account although such remittances may not relate to the profits of that period. A remittance of any dividend paid by a resident company does not form part of the remittance on which remittance tax is chargeable. A remittance to meet expenses which will be allowable in computing the profits of the company will not form part of the remittance on which tax is chargeable.

(b) **Any part of the proceeds of sale of products exported by the company which is retained abroad**: S. 34(2)(b).

In computing the amount of sale proceeds retained abroad as remittance for purpose of remittance tax, adjustment can be made in respect of expenses incurred in connection with the sale abroad. Such expenditure must be amounts which can be claimed as deductions in computing taxable profits of the non-resident company.

(c) **Profits which are deemed to have been made on any product exported by that company and not sold in a wholesale market or not sold at all.** S. 34(2)(c).

For the purpose of computing the amount of profits to compute remittance tax, in case of any product exported by a non-resident company and not sold in a wholesale market or not sold at all, such profits shall be deemed to be not less than the profits which might have been obtained if such person had sold such product wholesale to the best advantage. S. 71.

(b) **Wealth Tax**

A Non-Resident company having immovable property in Sri Lanka is liable to wealth tax on its taxable wealth at 1 %. The taxable wealth of a non-resident company is determined for an year of assessment by multiplying by five the taxable income attributable to the profits and income derived from its immovable property in Sri Lanka. Profits and income arising to a non-resident company from a unit of accommodation constructed with the approval of the Urban Development Authority and comprised in a registered condominium property is deemed not to form part of the profits and income derived by that company from immovable property for

1. 24 of 1980

the purpose of determining the taxable wealth of a non-resident company. S. 48(2).[1] A non-resident Banking Company is not liable to wealth tax. S. 42(h).

Example:

CD Ltd. a non-resident company, owns immovable property and also carries on an agency business in Colombo. The profits derived from immovable property is Rs. 200,000 and the profits from agency business is Rs. 1,000,000 for year ended 31.3.1982.

Computation of Wealth Tax liability

Taxable wealth 200,000 × 5	... =	*Rs.*	1,000,000
Wealth Tax payable at 1 %	... =	*Rs.*	10,000

The wealth tax liability is thus equal to 5 % of the taxable income attributable to the immovable property owned by the non-resident company.

16. **A Small Company.** S. 33(2)(b).

A small company is a company

(a) which is resident in Sri Lanka;

(b) the issued capital of which does not exceed five hundred thousand rupees, either throughout the year of assessment for which the taxable income is computed or from the date of incorporation of the company to the end of that year of assessment.[1]

(c) which has not reduced its issued capital on or after November 15, 1978; or

(d) which was not formed on or after November 15, by the reconstruction of an existing company or by the acquisition of any plant, machinery or fixture or building of an existing company.

A small company is liable to concessionary rate of taxation, if:

(a) EITHER such a company is a small company throughout that year of assessment;

(b) OR where such a company was incorporated in that year of assessment is a small company from the date of incorporation to the end of that year of assessment.

A small company can also qualify to be a Quoted Public Company and be entitled to concessions applicable to Quoted public companies.

The rate of tax applicable to a small company

A small company which is not a Quoted Public Company is liable to income tax at the following rates on its taxable income for an year of assessment commencing from April 01, 1982.[1]

On the first Rs. 50,000 of Taxable Income	—	20 %
On the next Rs. 100,000 of Taxable Income	—	30 %
On the next Rs. 100,000 of Taxable Income	—	40 %
On the balance of the Taxable Income		50 %

A small company which is a quoted public company will be liable to income tax at the following rates of income tax from April 01, 1980.[1]

On the first Rs. 50,000 of Taxable Income	—	20 %
On the next Rs. 100,000 of Taxable Income	—	30 %
On the balance of Taxable Income		40 %

1. 27 of 1982

Dividends declared by a small company

A small company which is not a quoted public company is liable to income tax on the aggregate amount of the dividends declared out of the profits on which taxable income of the company is computed for any year of assessment. The rate of tax the company is liable to on dividends paid is 20 %.[1]

A small company which is a quoted public company is not liable to pay tax on the dividends paid and can pay dividends gross to its shareholders without deduction of tax.[1]

17. **People's Companies.** S. 33(2)(a).

A People's Company is a company which furnishes evidence to the satisfaction of the Assessor that;

(a) it is not a private company within the meaning of the Companies Act;

(b) the number of shareholders of the company exceed one hundred and the nominal value of each share does not exceed ten rupees;

(c) any person may invest in one or more shares in the company at any allotment of shares by the company or in the open market;

(d) no person either individually or together with his wife or minor children holds, either directly or through nominees more than five percent of the issued share capital;

(e) there are three or more directors each owning one or more shares;

(f) none of the directors of the company holds office as director of any other People's Company; and

(g) it is a company in which no other company holds any share either direcly or through nominees.

A company will be considered a People's Company where all the foregoing conditions prevail either throughout that year of assessment or where the company was incorporated in that year of assessment, from the date of its incorporation to the end of that year.

A People's Company which satisfies these conditions will be entitled to be taxed at the concessionary rate of 40 % on its taxable income.

Dividends declared by a People's Company:

A People's Company is liable to income tax to a sum equal to 20 % of the aggregate amount of the gross dividend declared out of the profits on which the taxable income of the company is computed for any year of assessment.

A People's Company which is a quoted public company is not liable to pay the dividend tax of 20 % and can pay dividends gross to its shareholders without deduction of tax.

18. **Quoted Public Company.** S. 163[1]

Quoted Public Company is a company which is

(a) a company resident in Sri Lanka; and

1. 24 of 1980.

(b) satisfies the Assessor that it is a company the shares of which are quoted in the official list published by;

(i) the Colombo Brokers' Association; or
(ii) such other body approved by the Minister of Finance as a body performing functions similar to the functions performed by the Colombo Brokers' Association.

The objective of the government to induce corporate business to become broad based have found expression in the concept of Quoted Public Company, so that the fruits of prosperity are shared by a larger number of people as possible. Tax concessions provided to promote quoted public companies fall into two categories. They are

(a) **Tax Concessions**

(i) Concessionary rate of taxation at 40 % of the taxable income S. 33(1A)(a)(iii).[1]
(ii) No with-holding tax on dividends declared S. 38(i)(b).[1]
(iii) Exemption from income tax on the Capital Gains arising on the transfer of shares. S. 14(a)(xiii).[1]
(iv) Capital gains arising to a proprietor or partnership on conversion into Quoted Public Companies. S. 14(a)(xiv).[1]

(b) **Tax holiday for Quoted Public Companies approved by the Minister of Finance for a specific period.**

On the basis of the guidelines issued by the Fiscal Policy Division of the Ministry of Finance, quoted public companies which make available for public subscription at least 40% of the share capital will be considered for the grant of tax holiday. The 40% rule would be relaxed only in cases where the Government had already committed itself by offering tax concessions on the basis that a lower percentage of shares could be made available for public subscription. Any shares offered for public subscription, but not fully subscribed can be taken up by the promoters of the company. These guidelines will apply in respect of new companies seeking approval from the Minister of Finance.

A distinction is necessary in respect of quoted public companies approved by the Minister of Finance and quoted public companies as defined in the Act. A company may be able to obtain a quotation from the Colombo Brokers' Association (subject to the recommendation of the share sub-committee as to the reasonable percentage of the issued capital to be made available to the public) by offering less than 40% of the share capital for public subscription, and in such circumstances will be a quoted public company and will enjoy the concessionary rate of tax of 40 % and could distribute dividends gross, but will not be qualifed for tax holiday unless it conforms to the stipulation that 40 % of the shares were made available for public subscription or that the stipulated percentage of shares were made available to the public and on being not fully subscribed the promoters took over the balance of the shares.

1. 24 of 1980

The Minister of Finance will consider for approval made before 31.03.83 for the granting of Tax Holiday only to Quoted Public Companies carrying on the following undertakings:

1. Tourist Hotels. S. 16A	—	Exemption of profits for a period of 10 years for a Quoted Public Company with a subscribed capital of not less than Rs. 100 Million.
2. Mahaveli Contracts S. 22A	—	Exemption of profits for a period of five years to a Quoted Public Company.
3. Urban Development projects S. 22B	—	Exemption of profits for a period of 10 years to a company which becomes a quoted public company within two years from the date on which it commences to carry on business.
4. Import substitution and pioneering Industries S. 22C	—	Exemption for a period of five years to a Quoted Public Company.
5. Large Scale Agriculture S. 22D		Exemption of profits for a period of 10 years to a quoted Public Company.

19. Tax Incentives for Companies

With a view to encourage corporate form of business undertakings and to encourage investment in certain sectors substantial tax incentives have been provided, especially for limited liability companies. The incentives take the form of tax relief on the income of the person making the investment in the year in which such investment is made and the exemption of the profits of such companies from income tax with a further concession of exempting from income tax the dividends received by shareholders.

With a view to activating the share market, capital gains on sale of shares in quoted public companies and companies in the Investment Promotion Zone are exempt from income tax, in the hands of the shareholders. In order to make investment attractive dividends distributed by quoted public companies do not suffer deduction of tax and are therefore paid gross while in other resident companies a low refundable tax of 20 % is imposed. Further the concept of the small company, people's company and quoted public company also provide further concession by way of reduced taxation. As an encouragement for company formation preliminary expenses can be deducted in computing the profit of a company : S. 23(O): and capital gain arising on the conversion of proprietorship or partnership into a quoted public company is exempt from income tax.

The tax incentives available to companies are briefly described below; these are discussed in detail in Chapter 33.

(i) Tax holiday available only to company form of business undertakings.

Undertaking		*Incentives*
(a) Tourist Hotels	—	10 years tax holiday available to a quoted public company with a subscribed capital of not less than Rs. 100 Million. S. 16A.
(b) Fishing, Animal Husbandry Sericulture and agriculture	—	Tax holiday up to 31.3.1985 from the date of incorporation. S. 17.
(c) Large Scale Agriculture.	—	A 10 year tax holiday for a quoted public company with paid up capital not less than Rs. 100 Million. S. 22D.

(d) Contracts with Mahaveli Authority.	—	A five years tax holiday for a quoted public company. S. 22A.
(e) Urban Development.	—	10 year tax holiday for a quoted public company. S. 22B.
(f) Import Substitution and Pioneering Industries.	—	A five years tax holiday for a Quoted public company. S. 22C.
(g) Exports.	—	A five years of tax holiday. S. 20.

(ii) Tax holiday undertaking which a company can also undertake

(a) Tourist Hotels	—	A five year tax holiday from date of commencement of business. S. 16.
(b) Construction of Additional Rooms in Tourist Hotel	—	Five year tax holiday on profits related to the additional Bed Rooms constructed. S. 16B.
(c) Small and Medium Scale Industries.	—	Tax holiday up to 31.3.1983. S. 18.
(d) Paddy Milling	—	Tax holiday up to 31.3.1983. S. 19.
(e) Construction and sale of Houses or Flats	—	Profit exemption related to floor area of Houses or Flats. S. 21.
(f) Gem Business.	—	Exemption of profits on Exports, on Sale at Gem Auctions, on sale to State Gem Corporation and on sale for foreign currency. S. 15.[1]

Time limit for Approval of Tax Holiday[2]

The law has been amended to provide a time limit for approval for Tax Holiday by the Minister of Finance. The time limit and the projects in respect of which this time limit apply is tabulated below:

Projects		*Time limit for approval*
1. Tourist Hotels — S. 16, 16A, 16B		31.3.1983
2. Fishing, Animal Husbandry, Sericulture and Agriculture. S. 17.		31.3.1983
3. Export Undertakings. S. 20	—	31.3.1983
4. Mahaveli contracts. S. 22A	—	31.3.1983
5. Property Development. S. 22B	—	31.3.1983
6. Import substitution and pioneering Industries. S. 22C		31.3.1983
7. Large scale Agriculture. S. 22D	—	31.3·1983

Cancellation of Approval. S. 22E[2]

Where an undertaking has been approved by the Minister and the Commissioner General is satisfied that no steps have been taken to commence the undertakings within one year of such approval he may recommend to the Minister of Finance that such approval be cancelled. The Minister of Finance may, having regard to the interest of the economy by order published in the Gazette, cancel such approval.

The following projects will be required to comply with the requirement that steps must be taken to commence the undertaking within one year of approval

1. Tourist Hotels. S. 16
   S. 16A
   S. 16B

1. 24 of 1980 2. 27 of 1982.

2. Export Undertakings. S. 20
3. Import substitution and pioneering Industries. S. 22C
4. Large Scale Agriculture. S. 22D
5. Mahaveli Contracts S. 22A
6. Urban Property Developmet. S. 22B

(iii) **Exemption of Dividends of Tax holiday undertakings.**

Dividends paid to a shareholder by a company out of the profits and income which is exempt from income tax, is exempt in the hands of the shareholders, if such dividend is paid during the tax holiday period or within one year thereafter. S. 11(a) and (b).

The exemption of dividends is extended to dividends paid by a company out of exempt dividends received from another company provided such dividend is paid during any year of assessment in which such dividend was received or within one year thereafter. S. 11(c).[1]

20. **Approved Undertakings. (Companies)**

The claim for investment relief in respect of any investment in shares in companies can be made only in respect of shares in companies approved by the Minister of Finance by notice published in the Gazette. S. 31(9)(b). Approval is granted by the Minister of Finance only to undertakings carried on by a limited liability company and must be recommended by appropriate Ministry or authority. Usually, approvals are granted to undertakings that qualify for tax holiday and the guidelines applied to determine whether an undertaking is eligible to tax holiday will be applied by the Ministry of Finance for the grant of approved undertaking status. The approval is granted where the Minister of Finance is satisfied that such undertaking is essential for the economic progress of Sri Lanka.

On the basis of a communique issued by the Ministry of Finance the following undertakings carried on by a limited liability company will be eligible for approval as an approved undertaking.

(a) operating hotel for tourists or the expansion of existing hotels by providing additional rooms. S. 16(a); S. 16A; S. 16B.
(b) off-shore and deep sea fishing. S. 17.
(c) Agriculture other than tea, rubber, coconut or paddy. S. 17.
(d) Animal Husbandry. S. 17.
(e) Sericulture. S. 17.
(f) Processing of the products of any activity referred to in paragraph (b), (c), (d) and(e), so long as the processing is carried on in combination with such activity. S. 17.
(g) building fishing boats or manufacture of fishing gear or the manufacture or assembly of marine engines. S. 17.
(h) Manufacture of ice or provision of cold storage rooms. S. 17.
(i) Small or medium scale industries in a non-municipal area. S. 19.
(j) Paddy milling. S. 19.
(k) Export industries. S. 20.
(l) Performance of a contract entered into with the Mahaveli Authority. S. 22A.

1. 24 of 1980.

(m) Engaging solely in property development project. S. 22B.
(n) Import substitution industries and pioneering industries. S. 22C.
(o) Expansion of an existing industry where a company presently not enjoying a tax holiday is engaged in an activity as would have qualified for a tax holiday.
(p) Independent processing units which are set up to process local agricultural produce.

The companies which are approved by the Minister of Finance as an approved undertaking will have the approved undertaking status for a period of five years from the date of first issue of shares. Any new issue of ordinary shares by the approved company will qualify for investment relief as qualifying payment within the five year period.

The applications for approval are to be made to the Secretary to the Ministry of Finance and Planning, Fiscal Policy Division, who will require such application in triplicate. The following documents will also be required with the application.

(a) Memorandum and Articles of Association of the company;
(b) Certificate of Incorporation;
(c) List of names and addresses of Directors including nationality and the number of shares held by them.

21. Distribution of undistributed profits of Companies controlled by not more than five persons. S. 39.

Both private and public companies are treated alike for the purpose of taxation, although this distinction lies under the company law. A departure from the scheme of company taxation is the separate treatment of companies controlled by not more than five persons, in respect of the distribution of the company's profits to the shareholders.

The law regarding distribution in respect of these companies is an anti-avoidance provision directed against groups of persons who because of the smallness of the size of the group or because of the closeness of the relationship between the members of the group, would be capable of manipulating the affairs of the company to their own tax advantage. Such advantage may be the avoidance of the tax, the deferment of tax, or payment of tax at lesser rate than might have been payable if the affairs of the company had not been manipulated. It will be possible to use companies for the avoidance of tax by the accumulation of its profits free from the burden of high rates of personal taxation.

(a) Company controlled by not more than five persons. S. 39(7).

A company controlled by not more than five persons means a company in which more than half the total shares issued is held by not more than five persons, their wives or minor children, either directly or through nominees. This is the only test of control provided in the definition.

A company would be a controlled company if shares carrying more than fifty percent of the total voting strength were at any time during the accounting year held by not more than five persons. A group holding more than fifty percent of the shares would generally be able to have a dominant voice and would be able to fulfil their wishes with regard to the ordinary resolutions and in the election of the directors. Such a group, however, will not be able to pass a special or extraordinary resolution, which requires seventy five percent of the voting strength, but would be able to resist any resolutions which are not in accord with their wishes. The usual mode of exercising control over a company's affairs is by the possession of more than fifty percent of the voting power: *I.R. v. Harton Coal Co. Ltd.,* 39 TC 174. The control of the company will mean the control at general meeting to the voting power of the shareholders Pennycuick J. in *I.R. v. Harton Coal Co. Ltd.,* 39 TC 183.

> "It is established that the expression 'control' in relation to a company means the power by the exercise of voting rights to carry a resolution at a general meeting of the company......"

The situation behind the actual share register can be the deciding factor in ascertaining whether the directors in fact have controlling voting power. In the profits tax case of *Berendsen (S) Ltd., v. I.R.C.* 37 TC 517, an English company had an issued share capital of 1,000 shares each carrying one vote. The two directors held 401 shares, and 590 shares were registered in the name of a Danish company in which one of the aforesaid directors held a majority of the voting shares. It was held by the Court of Appeal that the two directors had a controlling interest in the English company because they could, directly as to part and indirectly as to part, by voting in respect of the shares registered in the name of the Danish company, exercise a voting majority in general meeting.

In deciding whether a company is controlled by not more than five persons, it will be necessary to examine the Memorandum, Articles and the share register of the company.

Date of determining whether a company is a controlled company

A company's situation in this respect is capable of changing rapidly from time to time and thus its position could remain uncertain for a long period. Normally, in the case of distribution of undistributed profits, it is the date of distribution which is the material date for determining the company's status

(b) **Profits which an assessor can deem distributed**

The amount of the profits which will come under the consideration of the Assessor will be the book profits of the company in respect of any year of assessment. In such an year of assessment the Assessor is satisfied that, the company has not distributed a reasonable part of its profits, he shall treat the whole or part of the profits as distributed, in the form of dividends to the shareholders on a date specified by him.

Distribution of the profits of the company will be considered when the Assessor is satisfied that the company has not distributed to its shareholders a reasonable part of its profits. He will then treat the whole or a part of the profits of the company after deducting therefrom any expenditure incurred for the development of the business of the company other than the price paid for the purchase of an existing business or an agricultural undertaking. S. 39(1).

(c) **Reasonable part of the profits of the company.** S. 39(2).

In determining whether a company has not distributed a reasonable part of its profits, the Assessor shall consider the following;

(a) the total amount of the profits;
(b) the additional assessment, if any, made on the company;
(c) the current requirements of the company's business; and
(d) such other requirements as may be necessary or advisable for the maintenance and development of the company's business.

What is a reasonable part of the profits which has not been distributed will be a question of fact, in all cases to be decided from a consideration of all the relevant circumstances: 19 TC 843. Since the application of this provision is a penal provision, the onus of proof that a company has not distributed a reasonable part of its profits will lie on the side of the State. At the same time, the onus of proof that a company has not unreasonably retained profits is on the company.

The amount of the profits that would normally be available for distribution will be profits which are in a commercial sense available for distribution, including capital gains. The reasonable profits that can be distributed bv a company for any year of assessment is so much of its distributable profits for that year of assessment as the Revenue can show that it can be distributed without prejudice to the requirements of the company's business.

In arriving at the amount available for distribution for any accounting period regard must be had not only to the current requirements of the company's business but also to such other requirements as may be necessary or advisable for the maintenance and development of that business. However, certain type of payments are to be regarded as income available for distribution and not as having been applied or as being applicable to the current requirements of a company's business or such other requirements as may be necessary or advisable for the development of that business.

The term 'requirements of the company's business or to such other requirements as may be necessary or advisable for the maintenance and development of the company's business does not limit the business to trade or activity or undertaking actually carried on at a particular point of time by the company. The company can retain its profits from distribution as dividends to undertake any activity which the objects clause permits in accordance with the Memorandum of Association. In the case of *Wilson and Garden Ltd. v. C.I.R.* STC. 301 C.S. (19 February 1981) Court of Session held that the business of any company was the application of any shareholders funds for the generation of profits in accordance with the Memorandum of Association and is not restricted to the particular trade or activity or undertaking actually carried on at a particular time. In this case the company which carried on the business of manufacturing chalk boards acquired the Ford Retail Dealership, which activity was *intra vires* the company in accordance with the Memorandum of Association. It was held that the moneys applied in the purchase of the dealership were necessary or advisable for the maintenance and development of the company's business.

The Companies Act No. 17 of 1982 provides in section 4 that every company shall set out specifically the primary objects which the subscribers or promoters intend that the company should carry out during a period of five years from the date of commencement of business by the company. Any other objects which the company, not being primary objects or of powers must be set out as a separate statement in the Memorandum and such objects cannot be carried out or exercised by the company except with the prior sanction of a special resolution of the company.

(d) **Sum regarded as profits available for distribution and not applied or applicable to the requirements of the company's business.** S. 39(3).

There are three categories of expenditure which are not regarded as having been applied or being applicable to the requirements of the Company's business or to such other requirements as may be necessary or advisable for the maintenance and development of that business.

(a) any sum expended or applied, or intended to be expended or applied, out of the profits of the company in the redemption or repayment of any share or loan capital or debt (including any premium on such share or loan capital or debt) issued or incurred otherwise than for adequate consideration.

(b) any sum lent to a director or shareholder of the company; and

(c) any sum expended or applied, or intended to be expended or applied, in pursuance or in consequence of any fictitious or artificial transactions.

(e) **Any sum expended or applied or intended to be expended or applied out of the profits of the company.**

This expression was considered in *Morris Securities Ltd. v. C.I.R.* 23 TC 525, where the facts were that in one period of account a company had:

(i) made a profit of £21,000;

(ii) applied £13,000 towards the payment for the first property of a substantial character in fact acquired by the company; and

(iii) the overdraft of the account from which the sum so paid was drawn increased £27,876.

On these facts the Revenue contended that the payment of £13,000 was made out of the income of the company. Lawrence J. commented.

"......I am of opinion that the argument on behalf of the Crown is right on this point, and it is impossible to say that when a company has in fact made a *bona fide* profit of £21,000, and has discharged a liability of a less sum than the amount of that profit, that liability has not been discharged out of income......"

The question of whether a sum has been expended out of profits can only be found by reference to the intention of the company.

"......It is not possible for any company ...... to say that any particular item of expenditure is derived from any particular item of incomings, whether of capital or revenue nature ...... even assuming that the company could show that during the year in question it kept a separate account of revenue receipts and revenue payments, that all revenue payments made by cheques drawn on that separate account, so that they could say, and say truly, that the money spent upon these requirements was drawn out of money received on revenue account, it still does not follow that in the end these expenses are going to be thrown into revenue. At most, it can be said that the money has been temporarily taken out of revenue, and it is for the directors to determine, at the time when they have to consider the question of what they will do with the profits, whether the sum so temporarily taken out of revenue is to be permanently allocated to revenue so as to capitalize the payments – that part of the revenue – or it is to be taken out of the capital assets ......" Romer J. in *Montague Burton Ltd. (In liquidation) v. C.I.R.* 20 TC 48.

(f) **Incurred otherwise than for adequate consideration**

Any sum expended or applied or intended to be expended or applied out of profits in redemption or repayment of any share or loan capital or debt (including any premium) issued or incurred otherwise than for adequate consideration is profit available for distribution among the shareholders. S. 39(3)(a).

A share or loan capital or debt shall be deemed to be issued or incurred otherwise than for adequate consideration if; S. 39(4).

(a) It is issued or incurred for consideration the value of which to the company is substantially less than the amount of the capital or debt (including any premium), or;

(b) It is issued or incurred in or towards or for the purpose of raising money applied or to be applied in or towards the redemption or repayment of any share or loan capital or debt which itself was issued or incurred for such consideration the value of which to the company is substantially less than the amount of the capital or debt, or which represents directly or indirectly, any share or loan capital or debt which itself was issued or incurred for such considerdation.

Any money applied or to be applied for any purpose shall include money applied in or towards the replacement of that money.

A company in 1920 applied part of the surplus shown on a revaluation of its capital assets in paying up in full ten thousand cumulative preference shares of £1 each, which it issued by way of capitalisation to the holders of its ten thousand ordinary shares. In 1951, the company by virtue of a special resolution and with the confirmation of an order of High Court, the capital was reduced from £20,000 to £10,000 by repayment of the whole amount of the Preference shares and the nominal capital was simultaneously again increased to £20,000 by issue of ten thousand new ordinary shares. In 1952, the company applied part of a surplus shown on further revaluation in paying up in full ten thousand ordinary shares of £1 each, which it issued by way of capitalization to the holders of existing ordinary share capital. Although, under the company law the transaction in question resulted in some benefit to the company, it was held that shares were issued otherwise than for adequate consideration in *C.I.R. v. Thornton Kelly and Co. Ltd.*, 37 TC 98: and accordingly direction requiring that the actual income of the company from all sources for years ended 30.06.1951 and 30.06.1952 be deemed to be income of the members of the company had been properly made. Although the company received some benefit from the ordinary shareholders in the issue to them of the Preference shares, in 1920, which were credited as fully paid yet the value of the consideration to the company was substantially less than the amount of the capital and accordingly, the shares were deemed to have been issued otherwise than for adequate consideration.

(g) **Sums regarded as profits available for distribution among the shareholders of the company and not as having been applied or being applicable to the requirements of the company's business or such other requirements as may be necessary or advisable for the maintenance and development of that business.**

Where in any year of assessment a company expends money out of profits for any of the purposes in paragraph 21(d) the Assessor can treat an amount equal to:

(i) the amount so applied or expended, and

(ii) the difference, if any, of the company's distributable profits. S. 39(3).

This is because the effect of this section automatically includes these amounts as profits available for distribution among the shareholders of the company.

"Any sum ...... regarded as income available for distribution among the shareholders of the company ...... and not as having been applied or being applicable to the current requirements of the company's business or to such other requirements as may be necessary or advisable for the maintenance and development of that business ...... That points to a complete and exhaustive antithesis between the distribution of income available for distribution among the members of the company on one hand, and money applied to the requirements of the company's business or requirements for the maintenance and development of the business on the other hand, which matter may be excluded ...... as forming a reasonable part. If that be the right view ...... it follows, that, when the statute speaks of 'income available for distribution to the members of the company', it means what it says, – those matters now become irrelevant with regard to the requirements of the business and the maintenance of the company – and is an express provision that the sum ascertained shall be deemd to be the sum available ...... in other words, that all parts so found available are reasonable parts......"

Slesser, L.J. in *Collier and Sons Ltd. v. C.I.R.* 18 TC 104.

(h) **What is a reasonable part? Some Judicial expressions**

"If the company has not distributed a reasonable proportion of its income – in the sense of this section – it appears that the whole of its undistributed income may be affected by the direction even though some part of that undistributed income might reasonably have been withheld for good business reasons from distribution......"

President Clyde in *David Carlow & Sons Ltd. v. C.I.R.* 11 TC 119.

When you find the words "a reasonable part" your attention is not being directed to a merely arithmetical question of proportion.

"A reasonable part" is a reasonable part for distribution and, therefore, you have to look at whether the act of refraining from distribution is reasonable. You cannot get away from that and treat the distribution as one thing not to be governed by reason, but the part has to be dissected as a matter of figures upon the principle of reason......"

Rowlatt J. in *Glazid Kid Ltd. v. C.I.R.* 15 TC 46.

"......the Act is certainly of a very sweeping character, and it has this very remarkable characteristic, that if it is determined that the company has not declared a reasonable amount of dividends, the whole of the profits become treatable as the income of the shareholders and not merely that part which would have been a reasonable dividend, the basis of it all being that the Act does not contemplate it ever being said what is a reasonable dividend. That is the basis of it, and therefore the whole inquiry is left in the vaguest possible shape; in fact, it goes very near to taxation at the discretion of the Board of Referees......"

Rowlatt J. in *London and Northern Estates Co. Ltd. v. C.I.R.* 16 TC 135.

(i) **Effect of the Distribution of the undistributed profits.** S. 39(5).

Where the whole or part of the profits of a company controlled by not more than five persons has been treated as distributed in the form of dividends to the shareholders of the company, such a company shall be liable to pay income tax for that year of assessment on the profits treated as distributed at the highest rate at which income tax is chargeable for that year upon the taxable income of an individual.

The tax payable by the company on the profits deemed to have been distributed is due in addition to and not in lieu of any income tax payable by the company.

The tax on the profits deemed distributed to shareholders shall be assessed by an Assessor and such tax can be recovered from the company under any of the recovery proceedings provided in the Act.

(j) **Controlled company in Liquidation.** S. 39(6).

Where a company controlled by not more than five persons is wound up in pursuance of an order made by a Court or on voluntary dissolution, the balance of the income after payment of income tax in the year of assessment in which such winding up is commenced and for each subsequent year of assessment until the winding up is completed, will be regarded as income distributed as dividends to the shareholders. S. 39(6).

22. **Gifts made by a company**

Taxable gifts made by a company will attract liability to gifts tax. S. 51. The company is liable to pay tax at 50 % on the value of all taxable gifts.

A company, however, is not liable to gifts tax on any gifts made to the Government, or to any local authority, or to any approved charity. S. 54(2).

23. **Death duty and the company.**

A company is an artificial person and cannot die although it can be wound up and on that account is not treated as equivalent to death. Thus the company is not liable to death duty but the shareholders will be liable, on their death, to death duty on the value of their shareholdings, When the property in the share passes on death, liability to death duty will arise.

24. **Capital Gains of the Company.**

A company is liable to tax on capital gains arising on the change of ownership of property and on certain types of transactions. The computation of capital gains or capital loss is made in accordance with the law and practice pertaining to the computation of capital gains, which has been discussed in detail in Chapter 20. The amount chargeable with tax is the net capital gains which is the excess of capital gains over capital loss of that company in that year of assessment.

The rate at which capital gains is chargeable with income tax is limited to a maximum rate of 25 per centum. S. 33(1B)(a)[1]

Rate of tax on Capital Gains of a small company. S. 33(1B)(b)[1]

The maximum rate at which a small company is liable to tax on capital gains is 25 percentum. The capital gain is aggregated with other sources of income of a small company and rates of tax is applied on such income. Since the rate of tax to which a small company is liable range from 20 % to 50 % of the taxable income, adjustment will be necessary when the income including capital gains is taxed at rates exceeding 25 percentum.

Where the part of the taxable income of a small company includes capital gains and the rate of income tax payable on a part of such income exceed 25 %, then tax payable is computed as follows:

(a) Where a part of the taxable income which include capital gains exceeds the amount of the capital gains, the tax payable on the capital gains is restricted to 25 % and the balance taxable income is taxed at rates exceeding 25 % applicable to a small company.

(b) Where that part of the taxable income including capital gains does not exceed the amount of the capital gains, then the entirety of that part of the taxable income is taxed at 25 percentum.

Example I

Income of a small company consists of the following sources of income:

Trade ...	...	...	Rs.	40,000
Capital Gains ...	...	...	Rs.	20,000
Total Income	...	...	Rs.	60,000

Computation of Tax payable is

50,000	@ 20 %	...	Rs.	10,000
10,000	@ 25 %	...	Rs.	2,500
				12,500

Example II

Income of a small company consists of the following sources of income:

Trade ...	...	...	Rs.	200,000
Capital Gains	...	...	Rs.	40,000
Total Income	...	...	Rs.	240,000

1. 40 of 1981.

Computation of Tax payable is

50,000	@ 20 %	... Rs.	10,000
100,000	@ 30 %	... Rs.	30,000
50,000	@ 40 %	... Rs.	20,000
40,000	@ 25 %	... Rs.	10,000
Total income tax payable		... Rs.	70,000

Exapmle III

Income of a small Company consists of the following sources of income:

Trade ...	...	... Rs.	20,000
Capital Gains	...	... Rs.	10,000
			30,000

Tax payable by the company is			
Rs. 30,000	@ 20 %	= Rs.	6,000.

25. Capital Loss of a Company in Liquidation. S. 29(d)(iii).[1]

Where a company is liquidated and such company has a capital loss for the last year of assessment for which it was liable to be assessed for income tax, the amount of such capital loss can be set off against the statutory income from all sources of the company for such last year of assessment.

Any capital loss which cannot be fully set off against the last year of assessment can be set off from the statutory income from all sources, of the three years of assessment immediately preceeding the last year of assessment.

Where any deduction in respect of capital loss has been made for any year of assessment, such assessment shall be revised notwithstanding that such assessment may be final and conclusive and any tax found to have been paid in excess shall be refunded.

26. Profits and Income appropriated by Directors etc.

Profits and income of a company appropriated by any Director, Manager, Shareholder or an executive officer of that company shall form part of the income of the person by whom such profits and income are appropriated and such person is assessable to tax on such profits and income. S. 40.

The principle of company taxation provides that no deduction can be claimed in respect of any disbursement of profits of the company and accordingly no deduction in respect of any appropriation of profits by a director, manager, shareholder or an executive officer of the company can be made in computing the taxable profits of the company. Such a position will result in the assessment of such profits both in the hands of the company and in the hands of such director, manager, shareholder or executive officer.

There may be circumstances where the company may allow such appropriation and waive the rights of the company to such profits, such company will find itself unable to deduct such amounts in computing its taxable profits and consequently is liable to account for the tax on such profits. The Commissioner General of Inland Revenue, may in his discretion, taking into account the circumstances of the case allow the deduction of such appropriation from the profits of the company for that year of assessment. S. 40.

1 40 of 1981

27. Valuation of shares in Companies.

Although the company is a legal person, maintaining a separate identity with its owners, the shareholders, and can hold property on its own account and has continuity of existence, the ownership, rests with the shareholders of the company. A shareholder is any member of a company having a share or interest in the capital or profits or income thereof whether the capital of such a company is divided into shares or not. S. 163. The Company continues to exist while its shares owned by various shareholders change hands at death, on sale or by gift. A share generally is a marketable security and for this reason is considered a movable asset representing value. The ownership and a change of ownership of shares will give rise to certain tax and duties on the value of the shares at the relevant date of possession and change of ownership. These are:

(a) Wealth Tax — A wealth tax at the appropriate rate on the market value of shares held by persons liable to wealth tax.

(b) Gifts Tax — A Gifts Tax at the appropriate rate on the market value of shares gifted by an individual.

(c) Capital Gains — A Capital Gains Tax at the appropriate rate on the gain arising on disposal of the shares computed in a prescribed manner by reference to its market value.

(d) Estate Duty — The market value of shares forming part of the estate of a deceased person will be included in the dutiable estate of that person and taxed at the appropriate rate.

(e) Stamp Duty — A stamp duty at appropriate rate is payable on the value of the share transferred.

The administration of the above taxes and duties are handled by the Department of Inland Revenue and the value determined for any one of the above purposes will normally be adopted for the sake of uniformity.

(a) Value of a Share

The value of a share is the price which it would fetch if sold in the open market at the valuation date. S. 49(2)(a) and S. 15(1) Estate Duty Act No. 13 of 1980. When a share is quoted in the official share list of a recognised Broker, such price will be generally adopted as the market value.

The Commissioner General may direct that in respect of the following companies the shares be valued by reference to the market value of all assets of the company as a going concern including goodwill: S. 49(2)(b).

(i) in a company which by its articles of association restricts the right to transfer its shares;

(ii) a company in which more than half of the total shares issued is held by not more than five persons or their nominees;

(iii) the Commissioner General is satisfied that the shares have not been quoted within twelve months of the valuation date by a recongised stock exchange.

(b) **The price which it would fetch in the open market**

"What is meant by words 'the price which it would fetch if sold in the open market' ...... is the best possible price that is obtainable and what that is largely, if not entirely, a question of fact". Sankey J. in *Ellesmere v. Inland Revenue Commissioners* (1918 – 2 K.B. at 740). It is nevertheless necessary to value shares at the relevant date by reference to the price which they would have fetched at a notional sale to a hypothetical purchaser "on the terms that the purchaser should be entitled to be registered and to be regarded as the holder of shares and should hold them subject to the provisions of the Articles of Association, including those relating to the alienation and transfer of shares in the Company" *C.I.R. v. Crossman* (1936) 1 A.E.R. 762. This principle laid down by the House of Lords, is seldom easy to apply in a particular case, as has been pointed out by Lord Flemmings in *Salveson's Trustees v. C.I.R.* (1930) 9 Annotated Tax Cases 43; "the estimation of the value of shares by a highly artificial standard which is never applied in the ordinary share market must be a matter of opinion and does not admit of precise scientific or mathematical calculation."

(c) **Market Value**

Market value with reference to any property has been defined as the price which in the opinion of the Assessor, that property would have fetched on that date in the open market. S. 163.

The price which the willing vendor could reasonably expect to obtain and a willing purchaser could reasonably expect to have to pay for the shares in question is the measure of the value under these sections of law regarding valuation. In order to estimate the price that a prudent purchaser might reasonably be expected to pay for the share it is necessary to examine all the relevant factors known at the date of valuation in order to determine what a prudent investor who knows all these facts might be expected to be willing to pay for these shares. The main factors for consideration would be:

(1) The nature of the business of the company;
(2) The history of the company;
(3) Future prospects of the business generally and of the valuation date;
(4) The state of the investment market at the valuation date;
(5) The extent, if any, to which the restriction contained in the articles of association might be expected to depreciate the value of the shares.

Having considered these factors, it will then be necessary to apply the method of valuation most appropriate to the case.

(d) **Methods of valuation**

Most commonly used methods of valuation are:

(1) Stock exchange quotation;
(2) Net assets or Balance Sheet basis;
(3) Yield basis.

The inherent nature of valuation concerned and numerous factors affecting the valuation, none of the above methods can claim to give an exact valuation. However, these methods will serve as a reasonable basis for arriving at a fair valuation of the shares.

1. Stock Exchange quotation

Ruling prices in the stock exchange will obviously reflect the market price of the shares, as these are the prices at which the transactions have taken place. Since this is the price on a particular day, reflecting the supply and demand on that day influenced by factors outside the business and thus will not reflect the true value of the shares of the company. However, the Revenue generally adopts the quoted share valuation as the market price of the Colombo Brokers' Association.

2. Net Assets or Balance Sheet method.

The assets are revalued as a going concern on the basis that the company is making a reasonable profit. The fact that the assets may be valuable does not necessarily follow that the assets will fetch its true value. The value of the share to be ascertained on the net assets basis is by taking the value of the assets of the company including good-will on the valuation date.

The balance sheet method of valuing shares in a highly speculative business, whose past history lacks evidence of any steady earning power, is the most appropriate method to adopt because it is not possible to arrive at a logical assessment of the future maintainable profits from which dividends could be paid to the shareholder as a return for his investment: Gratiaen J. in *Mackie v. Attorney General* in 1 CTC 512 Vol. II.

Good-will of the company which represents the "benefits and advantage of the good name, reputation and connection of a business" must also be included for the purpose of valuation. "There seems to be no doubt of the truth of the proposition that before it is possible to justify value being put upon the good-will of any undertaking it must be shown that the expected future annual profits exceed the normal annual wage or hire of the capital invested having regard to the nature of the risk", Leake on Goodwill, quoted in 2 CTC 397. In a speculative business one cannot expect profits but can only hope for profits and in such speculative business there can be no good-will. See *Mackie v. Attorney General* 1 CTC 39. Vol. II.

Methods of share valuations explained

(1) Yield Basis

The dividend yield basis will normally provide a valuable guide to arrive at a valuation. In the case of companies controlled by few shareholders the declaration of dividends is influenced by tax considerations. Further dividends may be low on account of ploughing back of profits. It is therefore a useful guide but does not provide a correct measure to valuation.

(2) Revenue or Earning Capacity Basis

This method does not provide a firm basis of valuation but can be used in conjunction with the net assets basis. Where the total net assets are not fully employed due to the failure of the management to exploit the full trade potential the earnings and dividend yield will not give a true value of the business. Consideration must also be given to the following:

(a) Earnings taken on the basis of published accounts do not reflect current performance;

(b) Profits may have been arrived at after;

(i) Heavy expenditure written off in one year;

(ii) Loss on unprofitable ventures written off;

(iii) Capital allowance in the form of lump sum depreciation may affect profit after tax.

Exercise of discretion by the Commissioner General of Inland Revenue to value shares on the net assets basis.

A departure from the valuation of shares at market value is the disrection vested in the Commissioner General of Inland Revenue to direct that in respect of certain companies to adopt the net assets basis of valuation. Unless the Commissioner General so directs the normal valuation described above will prevail and will apply to ordinary shares of the company.

Companies in respect of which the Commissioner General of Inland Revenue may direct that a valuation on the net assets basis are:

(a) a company which by its articles of association restricts the right to transfer its shares; or

(b) a company in which more than half of the total shares issued is held by not more than five persons or their wives, or minor children either directly or through their nominees; and

(c) the Commissioner General of Inland Revenue is satisfied that the shares of any company have not been quoted within twelve months of the valuation date by a recognised stock exchange.

As has already been discussed that in certain companies which did not declare adequate dividends and companies which have granted loans to its directors valuation on the yield basis cannot give a correct value.

The valuation in respect of such companies will be by reference to the market value of all the assets of the company as a going concern including goodwill after deducting the following:

(a) par or redemption value, whichever is greater, of any debentures, debenture stock or preference shares of the company;

(b) all *bona fide* debts of the company incurred or created *bona fide* for consideration in money or money's worth;

(c) just and fair computation of any future contingent liabilities of the company or any liabilities which are uncertain of amount;

(d) reserve funds invested to be applied exclusively for payment of pensions to employees or their dependants or relatives.

Example

The Balance Sheet of AD Ltd., as at 31.03.1982 is as follows:

Authorised and Issued Capital:		Rs.			Rs.
30,000 6 % Preference Shares of Rs. 10 each ...	... Rs.	300,000	Freehold premises at cost	... Rs.	480,000
80,000 Ordinary Shares of Rs. 10 each		800,000	Plant & Machinery at cost	...	745,000
		1,100,000	Investment at cost (Market value Rs. 250,000) ...	...	180,000
Revenue Reserves	Rs.				1,405,000
General Reserve	140,000				
Profit & Loss Account	250,000	390,000	Current Assets ...	...	365,000
		1,490,000	Preliminary Expenses ...	...	10,000
5 % Debentures ...	...	100,000			
Current Liabilities ...	...	190,000			
		Rs. 1,780,000			1,780,000

Net profits before declaration of dividends by the company for the last five years are as follows:

1978	...	315,000
1979	...	304,000
1980	...	287,000
1981	...	299,000
1982	...	334,000

The rate of return on similar companies is at 20 % while the dividend yield is 10% on ordinary shares and 5% on preference shares of similar class of companies respectively.

The freehold premises were valued to be worth Rs. 620,000 and plant and machinery is valued at book value. Valuation both at net assets basis and on yield basis is:

Valuation on the net assets basis:

Preference shares. The preference shares coverage is more than four times the net assets and therefore is valued at par, i.e. Rs. 10/- per share.

Ordinary shares.

	Rs.	Rs.
Freehold premises at market value		620,000
Plant & Machinery		745,000
Current Assets		365,000
		1,730,000
Less: Preference shares	300,000	
Current liabilities	190,000	
5 % Debentures	100,000	590,000
		1,140,000
Add: Investment at market value	250,000	
Goodwill	264,000	514,000
Net assets attributable to ordinary shareholders.		1,654,000

Value per share ... $\frac{1,654,000}{80,000}$ = 20.675, say Rs. 20

Valuation of Goodwill:

		Rs.	Rs.
Average profits for five years	... ...	...	307,800
Less: Investment income	... ...	9,000	
Preference share dividends	... ...	18,0000	27,000
			280,000
Less: Return on net assets employed, i.e. 20 % × 1,140,000	...		228,000
Super profits	... ...	...	52,800

Capitalised ... $52,800 \times \frac{100}{20} = 264,000 =$ Goodwill

Share Valuation of Yield Basis

6 % Preference shares: $\frac{6}{5} \times 10 =$ Rs 12.

Ordinary Shares: $\frac{20}{10} \times 10 -$ Rs. 20.

Share Valuation on Earning Capacity Basis.

Example:

A business earns an average of 20 % prior to appropriation on its net assets. The average rate of return of similar business is 15 %. The net assets of the company is Rs. 650,000 and the issued ordinary share capital is 50,000 ordinary shares of Rs. 10 each. The value of the ordinary shares is calculated as follows:

$$\frac{20}{15} \times 650,000 = 866,666.$$

Value per share is: $\frac{866,666}{50,000} = 17{\cdot}33$, say Rs. 17

(e) **Factors affecting the valuation of shares in Private Companies:**

A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place and of the interest in the second, but also consisting of a series of mutual covenants entered into by all shareholders in accordance with the Companies' Act. A shareholder has certain rights and privileges conferred on him by the articles and by the Companies' Act. It is erroneous to assume that all shares are of equal value, as the following circumstances may affect the share values:

(a) A shareholder acquiring over 25 per cent of the voting control would be prepared to pay a rather higher price, knowing that he could oppose special resolutions.

(b) A shareholder acquiring over 50 per cent can appoint directors, decide on dividends, and in effect control the company. For such privilege he would often be prepared to pay a considerable price.

(c) A shareholder acquiring 75 per cent can pass special resolutions which include a resolution to wind up the company.

(d) A director may be required by the articles of association to hold a certain number of shares. No shareholder has offered to sell his shares, so the existing directors agree to make shares available to him at a special price.

(e) A shareholder in order to satisfy his bankers is obliged to sell his shares. He is likely to find that the price he is offered is much below the price he had been advised his shares were "worth".

Discount for non-marketability of shares

As a matter of practice the Revenue normally allows a discout of 20 % of the values arrived in any of the above methods of valuation for non-marketability due to restrictive clauses in the articles of the company.

28. **Liability of Directors of Private Company in Liquidation.**
S. 141(1).

Where a private company is wound up and any income tax to which that company is liable cannot be recovered then, every person who was a director of the company at any time during the year of assessment in respect of which such tax is payable, are jointly and severally liable for such tax. However, a director of such a private company will not be held liable if he proves that the default in payment of tax cannot be attributed to any gross neglect, misfeasance or breach of duty on his part in relation to the affairs of the company.

The joint and several liability to unpaid tax of a company in liquidation applies only to the directors of a 'private company' as defined in the section 30(1) of the Companies Act No. 17 of 1982. A Private Company under the Companies Act is a company which by its Articles:

(a) restricts the right to transfer its shares;
(b) limits the number of its members to fifty; and
(c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

29. **Off-Shore Companies**

Exemption from income tax is available to off-shore companies in respect of certain business carried on by them. The exemptions apply to

(a) Off-shore shipping Companies; S. 8(a)(xxxviii).[1]
(b) Off-shore Banking Companies.[2]

An off-shore company is a company which is registered under section 241 of the Companies Act No. 17 of 1982. In the terms of section 241 of the Companies Act any company may make an application to the Registrar of Companies to be registered in Sri Lanka as an off-shore company and to be so referred to and in the case of a company incorporated abroad deemed to be continued in Sri Lanka as if it had been incorporated under the Companies Act.

An Off-Shore Shipping Company[1]

An Off-shore shipping company is exempt from income tax on the profits and income arising to such company from operations of a ship which is:

(a) engaged in international operations;
(b) owned by or chartered by such company; and
(c) deemed to be a Ceylon ship on the basis of a determination under section 30(c) of the Merchant Shipping Act No. 52 of 1971.

1. 27 of 1982 2. 24 of 1980.

An off-shore shipping company is not entitled to exemption from income tax in respect of profits and income arising to such a company from the carriage by that ship of passengers, mails, livestock and goods to or from a port in Sri Lanka.

In terms of section 30(c) of the Merchant Shipping Act No. 52 of 1971 a ship shall not be deemed to be a Ceylon Ship unless it is owned wholly by a body corporate as may be determined by the Minister.

An Off-Shore Banking Company

A Banking Company must be registered as a public company under section 412 of the Companies Act to carry on the business of banking in Sri Lanka, with the exception of an association or partnership formed outside Sri Lanka under a Royal Charter or Letters of Patent or incorporated outside Sri Lanka. Any such banking company may apply for registration under section 241 of the Companies Act No. 17 of 1982 as an off-shore Banking Company.

Exemption from income tax will apply to a foreign currency banking unit arising from all off-shore transactions of the unit and from such off-shore foreign currency transactions of the unit as may be approved by the Minister having regard to the foreign exchange benefits that are likely to accrue to the country from such transactions. S. 8(c)(iv).[1]

A foreign currency banking unit means a unit or department of a commercial bank authorised by the Central Bank of Ceylon to operate as a foreign currency banking unit. S. 163.[1]

1. 24 of 1980.

Chapter 7

TRUSTS

A Trust is created to give effect to present intentions as to disposition of property. When a trust is created, it will be administered in conformity to the intention of the settlor and the trust is not capable of modifying its own constitution in the manner an association, incorporated or unincorporated is capable of modifying its own constitution. The intention of the settlor can be found in the trust instrument or can be implied from the trust instrument.

Trust is the confidence reposed in a person by making him nominal owner of property to be used for another's benefit. Thus the trustee is the legal owner in whom the property vests, while the beneficiary is the equitable owner for whose benefit, the trustee administers the property in accordance with the provisions of the trust instrument.

A trust comes into creation when a person usually a settlor or a testator devises property by transfer to another in such a manner to compel him in equity to administer the property for the benefit of the beneficiary in a prescribed manner. Trust comes into existence by creation in wills and family settlements and also formed for endowments of charities.

There are two classes of trusts; Trusts and Charitable Trusts each having separate tax consequences. Tax rate of a trust is 50 % where the trust was created before 15th November 1978 and 55 %[1] where the trust was created after 15th November 1978, while the tax rate for a charitable trust is 20 %. No portion of the trust income is exempt from income tax while in the case of charitable trusts certain exemptions are available if it comes within the definition of a charitable trust.

Trustee.

Trustee includes any trustee, guardian, curator, manager or other person having the direction, control or management of any property on behalf of any other person. S. 163. An Executor of the estate of a deceased person is not a trustee. S. 163. The Trustee is bound to act within the authority of the trust instrument in the administration of property vested in him and is chargeable with income tax and wealth tax on the income and wealth of the trust. Trustee is chargeable with tax on the whole of the income of the trust unless the trust provides that the beneficiaries are entitled to a share of the income of the trust. In such an event the share of the beneficiary's income is deduc-

1. 24 of 1980.

ted from the income of the trustee. S. 60(2). If the beneficiaries are not entitled to any part of income of the trust, the whole of the income and wealth is assessable to tax on the trustee.

2. Distribution to the beneficiaries

The amount of the income that the beneficiaries are entitled to will depend on the terms of the trust deed, giving the trustee the power to distribute income. The beneficiaries must in the first instance be ascertainable and identifiable and the intention of the person creating the trust must be clear and should not be vague or preposterous. Where a non-charitable trust is expressed in favour of a particular cause or set of principles such trust cannot be a legally acceptable trust and the trustee may not be able to distribute income to the beneficiaries. Where the beneficiaries are not capable of ascertainment the trustee has no power to distribute income. A trust for members of a given class or objects as the trustee should select was void for uncertainty unless the whole range eligible was capable of ascertainment [Re Ogden (1933) Ch. 678].

However, in Re Gestetner Settlement (1953) Ch. 672 Harman J., described the position of the trustees as follows:–

> "They are bound, as I see it, to consider at all times during which the trust is to continue whether or not they are to distribute any and, if so, what part of the fund and, if so to whom they should distribute it ...... the settlor had good reason, I have no doubt, to trust the persons whom he appointed trustees; but I cannot see here that there is such a duty as makes it essential for these trustees, before parting with the income or capital, to survey the whole field, and to consider whether A is more deserving than B – that is a task which was and must have been known to the settlor to be impossible having regard to the ramifications of the persons who might become members of this class".

It should be thus seen that unless the trust's objectives are clearly stated in the trust instruments then, it will involve the failure of the trust and might imperil the validity of otherwise deserving objectives. In such an event the whole of the trust income will become assessable in the hands of the trustees without any deduction of any distributions made by the trustees under any implied discretionary power to do so.

3. Share of income to which beneficiaries are entitled

Where there are any beneficiaries to a Trust the income of which is liable to income tax then the share of the income to which such beneficiaries are entitled shall be deducted from the amount of the income liable to tax to arrive at the income chargeable on the trustee. The amount of the income so deducted shall be considered as the income of the beneficiaries. S. 60(2).

In terms of the trust law the beneficiaries cannot in law claim from the trustee any thing more than the trust deed gives them. But the tax law can and does ignore the trust and the trust law concept of income. The income of the beneficiaries assessable to income tax is on the share of the income of the trust and not his entitlement. *(Esufally Trust v. C.I.R.:* S.C. 1, 2, 3, 4 of 1969). In this case the appellants contended that under the trust deed the entitlement of the beneficiaries is only to so much of income as collected by the trustees after making the deductions for the purpose of preserving the property, legal expenses, etc. and that the beneficiaries are only entitled to the balance of the income so computed: Gunasekera J. in his judgment said:

"On the obvious intent and purpose of this section and the plain words therein, there cannot be the slightest doubt that the only meaning of the word 'income' in the proviso is the income of the Trust property and not the entitlement of the beneficiary in terms of the Trust deed. ...... Section 26 of the Income Tax Ordinance says that the part of the income to be taxed as belonging to the beneficiary is to be 'treated for the purpose of the Ordinance as the income of the beneficiary': Section 47 of the Inland Revenue Act similarly says it may be 'considered' so. The income actually received by the beneficiary or entitlement need not be treated or considered to be his income because unquestionably it is his income in fact. It is only what is not in fact so, that for the purpose of Tax Law, need not be treated or considered to be the income of the beneficiaries and what in terms of the Trust Deed and the Trust Law is considered the income of the Trustees has by this proviso been deemed to be that of the beneficiary.

...... The proviso also requires that the share of the income of the beneficiary must be deducted from the 'amount on which trustee is assessable'. The income on which the Trustee is assessable is the income of the Trust property liable to tax in his hands, and the income of the beneficiaries which is to be deducted from that must be of the same kind, viz., a share of that income to which the beneficiary is entitled. If the proviso refers to the entitlement it should be deducted only from the taxable income of the Trust."

4. Trustee of an incapacitated person

Where a trustee had been appointed to administer the affairs of an incapacitated person, such trustee is chargeable with income tax in the like manner and to the like amount as the incapacitated person would be chargeable. S. 61. Incapacitated person means any minor, lunatic, idiot, or a person of unsound mind. S. 163. In these cases the tax will be calculated on the basis applicable to individuals with entitlement to tax free allowances and charged at rates applicable to individuals. The trustee is obliged to make payment of tax even though the assessment may not have been issued in the name of the incapacitated person. S. 60(4).

5. Wealth Tax

A trustee is liable to wealth tax on the value of the net wealth of the Trust. If the value of the share of the net wealth of the beneficiaries can be ascertained from year to year then, such share is assessable on the beneciaries as is proportionate to his share of the benefits from the trust. S. 44(i)(d). Where there is one sole beneficiary the entire net wealth of the trust is assessed on the beneficiary. S. 44(1)(c).

Where the shares of the benefits of the beneficiaries cannot be ascertained the trustee will be liable to wealth tax on the entire net wealth of the trust. S. 44(1)(e). The trustee of a charitable trust will be liable to wealth tax on the net wealth of the trust other than any property the income from which, or the annual value of which is exempted from income tax. S. 45(ii).

6. Capital Gains

There is no liability to capital gains tax on the passing of property from a trustee to a beneficiary. S. 14(a)(v). However, there will be liability to capital gains tax where the property is transferred to any other person other than a beneficiary.

7. Creation of Trust and Gifts Tax

A transfer of property to a trust will attract liability to gifts tax on the settlor. A gift made to an approved charity provided that value is not less than Rs. 1,000 subject to a maximum of Rs. 500,000 during the life-time of the donor is exempt from gifts tax, provided the gift is to an approved charity. S. 54(1)(d).[1]

8. Duties of the Trustees

A trustee is obliged to furnish a return of income and wealth of the trust. He must also make a return of the properties subject to trust and the names and addresses of the beneficiaries under the trust and the benefits to which they are entitled. S. 60(1)(b).

Where a beneficiary is entitled to the entire or part of the income or net wealth of a trust the trustee should give notice to such beneficiary giving details of the amount of income or wealth on or before the thirtieth day of July, October and January of that year of assessment and on or before 30th April of the immediately succeeding year of assessment. S. 60(3).

9. Payment of Income Tax and Wealth Tax

Income tax and wealth tax payable by the beneficiaries in respect of the share of income and wealth to which they are entitled to, can be recovered from the trustee although no assessment has been made on the trustee. S. 135. In such circumstances the trustee is entitled to deduct such amount of the payment made by him from the income of the trust to which the beneficiary is entitled.

A trustee is indemnified against any person whosoever, if he retains out of any assets coming to his possession or control such an amount which is sufficient to meet the tax liability in the event that the trustee is chargeable with the tax or is recoverable from him. Where the trustee has paid tax and that there are no assets of the trust or he has no control over any assets out of which he could retain the tax paid, then, such an amount shall become a debt due to the trustee. S. 148(1) and (2).

10. Payments to beneficiaries – Capital or income?

It may sometimes happen that the trust income is not sufficient to pay the beneficiaries under the terms of the trust. Sometimes trustees are empowered to make the deficiency out of capital. Thus question will arise whether the amount received by the beneficiary is capital or income. In the case of *Trustees of Brodie, Deceased v. C.I.R.*, 17 TC 432, a deficiency of the income payable to a widow was to be made up to £4,000 a year by recourse to capital. Finlay J., held that since the payments were stamped

1. 24 of 1980.

with the character of income in the hands of the recipient, that character remained impressed on them in the hands of the payer despite the fact that the payments were derived from trust capital. This decision was approved by the Court of Appeal in *Curnad's Trustees v. C.I.R.*, 27 TC 122, where the trustees made discretionary payments out of capital to maintain the beneficiary's standard of living. In the case of *Peirse-Duncombe Trust v. C.I.R.*, 23 TC 199, the trustee borrowed in order to keep up the annuities and it was held that all amounts which ended up in satisfaction of the annuities as income.

Chapter 8

CHARITABLE INSTITUTIONS

Charitable institutions perform a very necessary social and religious function. These institutions are not profit making institutions, though sometimes they carry on such activities in order to collect funds for the pursuit of the objectivies of these institutions. They function in order to alleviate certain social, educational and religious needs of the society which the governmental institutions are not in a position to fulfil satisfactorily. In view of the role these institutions play such institutions are entitled to exemptions from income tax in respect of certain sources of income.

Exemption from income tax apply in respect of following sources of profits and income;

(a) Business carried on by a Charitable Institution,
(b) Casual business profits of certain institutions,
(c) Net Annual Value,
(d) Royal or other grants prior to March 02, 1815.

1. **Business Carried on by a Charitable Institution.** S. 8(d)(i)(a).[1]

The business profits of a charitable institution will be exempt from income tax where the following conditions are satisfied;

(a) the profits of a business carried on are applied solely to a charitable purpose; and, either,
(b) the business is carried on in the course of the actual carrying out of a primary purpose of that institution; or
(c) the work in connection with the business is mainly performed by beneficiaries of the institution. S. 8(d)(i).

In order to qualify for exemption not only the profits must be applied solely for a charitable purpose, but also the business must be carried on as a primary purpose of the institution or the work in connection with that business must be performed by the beneficiaries. The application of the profits as well as the carrying on of the business is relevant for qualifying for exemption.

A charitable institution may not qualify for exemption although its profits are applied solely for the charitable purposes, where the profits did not arise from carrying out this primary purpose of the institution or where beneficiaries did not carry on that business.

1. 24 of 1980.

Profits of a hospital established for medical relief or a religious institution managing a school will qualify for exemption where the profits are applied solely for a charitable purpose, as such business will be within the primary objective of that charitable institution.

Profits on the sale of any products made by inmates of a house for the aged, or an orphanage for handicapped children will qualify for exemption where such profits are applied solely for a charitable purpose as the work in connection would be done by the beneficiaries.

In each of the above cases the profits must be applied solely for a charitable purpose. Such a position would be a question of fact and would be arrived at by the examination as to whether any profits have been applied to any purposes which are not within the purposes of that institution. Where the profits have been spent for non-charitable purpose, the entirety of the profits of the charitable institution will be liable to income tax. In the case of *Trades House of Glasgow v. C.I.R;* 46 TC 178, where the income of the fund was applied towards the maintenance and improvement of the Trades Hall. It was held that the purposes of the fund included a charitable purpose, but since the application of the income to upkeep the hall was not for charitable purposes only, the claim for exemption failed.

2. **Casual Profits of certain institutions.** S. 8(d)(i)(b).

Where a charitable institution which receives grants from the Government of Sri Lanka and is approved by the Minister of Finance for the purpose of exemption carries on any business of a casual nature, such profits will be exempt from income tax. The profits derived from casual business of carrying on carnivals, benefit shows etc. for the purpose of raising funds will qualify for exemption.

3. **Net Annual Value.** S. 8(d)(ii).

The net annual value of;

(a) any place of public worship and its premises administered by such institution;

(b) place or premises owned and occupied by such institution solely for any purpose of that institution;

is exempt from income tax.

4. **Royal Grant Prior to March 02, 1815.** S. 8(d)(iii).

The profit and income of any property donated by royal or other grant before March 02, 1815 to any place of public worship administered by such institution, where such profits and income are applied for the purposes for which such grants were made is exempt from income tax.

5. **Definition of Charitable Institution**

A Charitable Institution is defined as:

(i) the trustee or trustees of a trust; or

(ii) a corporation; or

(iii) an unincorporated body of persons;

established for a charitable purpose only or engaged solely in carrying out a charitable purpose. S. 163.

6. Charitable Purpose

Charitable purpose is defined as a purpose for the benefit of the public or any section of the public in or outside Sri Lanka of the following categories:–

(i) the relief of poverty;

(ii) the advancement of education or knowledge;

(iii) the advancement of religion or the maintenance of religious rites and practices or the administration of a place of public worship;

(iv) any other purpose beneficial or of interest to mankind not falling within any of the preceeding categories. S. 163.

7. Charitable Trust

A charitable trust is a trust established for a charitable purpose only or engaged solely in carrying out a charitable purpose. The public character of a trust is ascertained from the objects of the trust; in that it must be for the benefit of the public or a section of the public.

"(A charitable trust) ...... cannot be validly established unless it falls within the definition of 'charitable trust' which is contained in S. 99(1) of the Trust Ordinance 1918. This definition includes any trust for the benefit of the public or any section of the public falling within any one of a number of categories which extend to such purposes as the relief of poverty and the advancement of education or knowledge. To satisfy the definition contained in the Income Tax Ordinance therefore the ...... Trust must be a charitable trust "of a public character; to be a subsisting charitable trust at all it must be a trust for the benefit of the public or some section of the public."

Lord Radcliff in the case of *M. Falil Abdul Gafoor and others v. C.I.R.* 3 CTC 96.

A charitable trust which has not been established for a charitable purpose only may be able to claim exemption if that institution was engaged solely in carrying out a charitable purpose during any year.

In order that a trust can be considered a charitable trust it must be for the benefit of the public or a section of the public. Viscount Simonds in the case of *Oppenheim v. Tobacco Trust Co.* (1951), A.E.R. 31 said:

"It is a clearly established principle of the law of charity that a trust is not charitable unless it is directed to the public benefit. This is sometimes stated in the proposition that it must benefit the community or a section of the community. Negatively it is said that a trust is not charitable if it confers only private benefits."

The test to be applied to determine whether a trust is a charitable trust or not is laid down by Lord Radcliff in the case of *M. Falil Abdul Gaffoor and others v. C.I.R.* 3 CTC 96.

"To test whether any particular trust is a charitable one what must be asked is whether the income is bound with certainty to be applied to charitable purpose, not whether it may be so applied."

In this case the trust was for an educational purpose and the recipients of benefits were 'deserving youths of the Islamic faith,' the primary disposition of the trust income was in favour of the family of the grantor, was held to be not a trust of a public character established solely for charitable purposes.

"The essential attributes of a legal charity are, in my opinion, that it should be unselfish – i.e. for the benefit of other persons than the donor – that it shall be public, i.e. that those to be benefited shall form a class worthy in numbers or importance, of consideration as a public object of generosity, and that it shall be philanthrophic or benevolent – i.e. dictated by a desire to do good."

Fitzgibbon L.. J. M. *Re Cranston* [1898: 1(r). R. 431.].

8. **For the benefit of the public or a section of the public.**

When the benefit is essentially or substantially for the public benefit it can be considered to be within the concept of 'for the benefit of the public or a section of the public. If there are any rights of preference dependant on qualification which cannot be fulfilled by any member of the public as such, then there will be no certainty or assurance that members of the public can benefit. The right to enjoy the benefit must not be merely theoretical or uncertain of the class or section of the public designated in the trust instrument.

"An aggregate of individuals ascertained by reference to some personal tie (i.e. of blood or contract) such as the relations of a particular individual, the members of a particular family, the employees of a particular firm, the members of a particular association, does not amount to the public or a section thereof".

From the Judgment of Jenkins L.J. in *Re Scarisbrick's Will Trusts* (1951) 1 A.E.R. 822.

In *Powell v. Compton* (1945) (Ch. D. 123) Lord Green thought that a "gift under which beneficiaries are defined by reference to a purely personal relationship to a named propositus cannot on principle be a valid charitable gift". The test is whether, although a class or section of the public is designated in the instrument, members of that class or section can as such, qualify for the benefit.

9. **The advancement of Religion**

The sphere of activity should rank as religious, and the courts will not enter considerations of the characteristics of religion or whether the followers are members, provided that they exist. The gift to be charitable it must be for the advancement of religion. The law is concerned with religion only in its impact upon the public at large who must have access, not fettered by prior adherences to particular tents, although with due regard for decorum. The making of the central act of worship of the community in public was a mode of promoting religion which confers a public benefit. The performance of masses for the benefit of certain individuals necessarily benefits a section of the public, namely, the worshippers at the church at which the masses are held: *C.I.T. v. Croos Raj Chandra,* 3 CTC 226.

10. **Advancement of Education**

To be considered charitable the benefit must be to some cross-section of the community, considered in its public capacity e.g. gift for education within a locality, or within a profession. A gift for the education of the descendants of a particular person, or of the descendants of several persons is not charitable, nor is a gift for the education of the children of employees, or of ex-employees of a firm; *Openhein v. Tobacco Securities Trust* (1951) A.C. 297. Charities for the advancement of political education cannot come within the definition of advancement of education as it is not possible to judge whether a proposed political philosophy or any political change will be for the benefit of the public or not.

11. Relief of Poverty

The trusts or gifts for the relief of poverty have been held to be charitable even though they are limited to their application to some aggregate of individuals ascertained and would apply even if there is personal tie of blood or of contract. Gifts for the relief of poverty have always been regarded as charitable, whether such gifts are sums of money for direct and immediate distribution, or whether they are directed to be applied for some more permanent end, such as the support of an organisation whose object is the relief of poverty, or the establishment of institutions such as alms-houses or homes for the aged. The gifts must be for the relief of poverty among some class or section of the community; gifts for the benefit of poor relations of the donor *(Walso v. Caley* (1809) 16 Ves 206; *A.G. v. Price* (1810) 17 Aes 371 and gifts for the benefit of the widow and children of deceased ex-employees of a firm, have been held as charitable.

Poverty is not an absolute concept, that is, there is no condition that the recipients of gifts for the relief of poverty must be destitute. There can be for example, perfectly good charitable gifts for the assistance of persons with limited means *(Re Gordon, 1914)* and where there is gift for those members of a class or profession who are in need. The requirement of poverty is determined by reference to the general standard of profession or class.

12. Other Charitable Purpose

It is possible to bring under this head institutions established in the interest of social welfare and are for the benefit of the public as charitable institutions.

It is difficult to bring a particular purpose within the definition of "other purpose beneficial to mankind" for the requirement that it must be for the benefit of the public is rather restrictive, One cannot, therefore, find defence by claiming that a public purpose beneficial to the community is necessarily charitable *(Trustees of William Trust v. C.I.R.*, 27 TC 409).

13. Computation of profits

The computation of profits liable to income tax is approached by applying the provisions of the Act and practice relating thereto.

14. Taxable income of a Charitable Institution. S. 30(2)[1]

The taxable income of a charitable institution is the assessable income of that institution for that year of assessment after deduction of the following;

(a) an allowance in respect of qualifying payments made by the charitable institution in that year of assessment; and

(b) an allowance of Rs. 12,000.

1. 24 of 1980.

15. Rate of Tax

The rate of tax at which income tax is chargeable on the taxable income of a charitable institution is 20 %.

16. Computation of Profits

The computation of profits liable to income tax is approached by applying the provisions of the Act and practice relating thereto.

17. Calculation of Income Tax

The taxable income of a charitable institution is arrived at after deducting an allowance in respect of any qualifying payment and an allowance of Rs. 12,000.

Example:

The assessable income of a charitable institution for the year ended 31.3.1983 is Rs. 30,000. The charitable institution purchased shares for Rs. 10,000 in an approved undertaking. The tax payable for the year of assessment 1982/83 is computed as follows:–

Assessable Income		Rs. 30,000
Less: Qualifying Payment	Rs. 10,000	
Tax free Allowance	12,000	22,000
Taxable Income		Rs. 8,000
Income Tax Payable=8,000 @ 20 %		Rs. 1,600

18. Wealth Tax

A charitable institution is liable to wealth tax. In computing the wealth of a charitable institution the value of such property the income from which or the annual value of which is exempt from income tax is excluded. S. 45(u).

The taxable wealth of a charitable institution for an year of assessment is such part of its net wealth as exceeds Rs. 200,000.

The rate of wealth tax applicable to a charitable institution is ½ % of all its taxable wealth.

19. Charitable Institutions as Approved Charities

Charitable institutions which are engaged in any one of the following activities are eligible for approval provided these are either societies registered under section 5 of the Societies Ordinance (Chapter 123) or Associations and Institutions recommended by appropriate government authority:-

(a) relief of poverty,

(b) medical relief,

(c) advancement of education.

Religious institutions do not qualify for approval. However, institution or fund which is set up for the construction or restoration of a place of worship will be considered for approval on production of a certificate from the Department of Cultural Affairs or Department of Social Services or Department of Probation and Child Care Services or the Archaeological Department.

Where an institution is engaged in several activities some of which are outside the scope of the objects enumerated above, approval will be granted to a particular activity of the institution e.g. Educational Fund, Medical Fund etc. so long as the institution is in a position to maintain separate accounts and utilise the monies in the fund solely for the purpose for which approval is sought. (Taxation 1981/82 Department of Inland Revenue).

20. Gifts to Charitable Institutions, which are Approved Charities

A gift to an approved charity up to a maximum of five hundred thousand rupees in value for the life time of an individual is exempt from Gifts Tax. S. 54(d).[1]

1. 27 of 1982, 24 of 1980.

Chapter 9

PARTNERSHIP

Partnership is a conception defined as the relationship which subsists between persons carrying on business in common with a view to profit. Partnership, however, is not a legal person, though there is provision to make an assessment on the partnership. S. 66(1). Partnership can be established by agreement between partners, either written, verbal or be implied by conduct of the partners. The Prevention of Frauds Ordinance requires that partnership with a capital of over Rs. 1,000 should be established by written agreement; but the absence of any written agreement does not prevent third parties getting remedy where evidence leads to the conclusion to the implied existence of partnership. Partnership can be established either by implication or by agreement. The Business Names Registration Ordinance requires that a Partnership be registered if the name of the business is different from that of the partners.

It is always a question of fact whether an enterprise falls within the definition of partnership and a review of the arrangement between persons acting together as well as the nature of their activities is necessary to establish partnership. A transaction in joint account may or may not suggest the existence of partnership. It is useful to quote the judgement of President Clayde in *C.I.R. v. Williamson* (14 TC 365) which gives in a nutshell the considerations that could be looked in to establish the existence of a partnership.

"You do not constitute or create a partnership by saying that there is one. The only proof that a partnership exists is proof of the relations of agency and community in losses and profits and of the sharing in one form or another of the capital of the concern; the only proof of the partnership consists in proof of these things. No doubt the proof may be supplied by what in fact the persons alleging themselves to be partners have done during the currency of the alleged partnership. For instance, if they had treated the capital as if it were partnership capital perhaps I should say and if they had treated the profits or losses as partners would treat them and in fact if there are facts or circumstances to show that their relations were those consistent with partnership, then no doubt the thing can be proved."

The Revenue sometimes questions the existence of partnership in cases where there is evidence that the partnership is fictitious. An individual may be able to avoid the incidence of high rate of taxation by spreading the income among the family members who are partners of a fictitious partnership and achieve reduction of tax paid on his income. Where the Assessor is of opinion that a partnership is fictitious then he has the right to question the existence of a partnership in terms of section 91 and may refuse to allow the division of the profits of the partnership.

In the case of *Davoodbhoy v. C.G.I.R.* S.C. 9/79 an agreement by one partner of a partnership to share his share of profits and losses with his children while the share of capital and goodwill of the main partnership remained the separate asset of the father, was held a valid partnership and the argument that such an agreement was artificial and fictitious by the Revenue was rejected by the Supreme Court. Commenting on the agreement, Samarakoon C.J. said,

"No doubt the Assessee has the right to terminate the agreement and until such termination he remains the owner of the capital and goodwill. This is a perfectly legal document. It incorporates a family arrangement by which a father is seeking to provide for his children a most natural desire, and if so minded, the children could even enforce it in law. This kind of family arrangement is not only genuine but very common in our society. To brand it as artificial and fictitious is unwarranted and unjust. It incorporates a perfectly legitimate family transaction. For acts and documents to be a 'sham' with whatever legal consequences to follow from this all the parties thereto must have common intention that the acts and documents are not to create the legal rights and obligations which they give the appearance of creating "per Diplock L.J. in *Snook v. London and W. Riding Investment Ltd.,* (1967) I.A.E.R. 518 at 528. The accounts up to 31.3.1966 show that this agreement has been acted upon and profits divided in terms of A,. I therefore reject the contention that it is artificial and fictitious."

A sub-partnership would be a perfectly valid partnership and the liability of such sub-partnership is determined in accordance with the provisions applicable to partnership.

"The term "sub-partnership" is merely a convenient name used in law and in commercial circles to describe a partnership which is dependant on another partnership commonly called a "principal partnership". These are merely nomenclature that have no significance in law. They are well known to the law of Sri Lanka. The position in English law which should also be the applicable law here, is described by Lindlay as follows:-

"A sub-partnership is at it were, a partnership within a partnership It presupposes the existence of a partnership to which it is itself subordinate. An agreement to share profits only constitutes a partnership between the parties to the agreement. If, therefore, several persons are partners and one of them agrees to share the profits derived by him with a stranger, this agreement does not make the stranger a partner in the original firm. The result of such an agreement is to constitute what is called a sub-partnership, that is to say, it makes the parties to it partners *inter se* but it in no way affects the other members of the principal firm. In the language of civilians, *Socius Mei Socii, Socius Meus non est.* In *Ex. p.* Barrow Lord Eldon puts the law on this subject very clearly: "I take it, he says, "to have been long since established that a man may become a partner with A where A and B are partners and yet not be a member of that partnership which existed between A and B. In the case of Sir Chas Raymond, a banker in the city, a Mr. Fletcher agreed with Sir Chas Raymond that he should be interested so far as to receive a share of his profits of the business and which share he had a right to draw out from the firm of Raymond & Co. But it was held that he was no partner in that partnership: had no demand against it: had no account in it; and that he must be satisfied with a share of the profits arising and given to Sir Chas Raymond" – Vide Lindley on Partnership ED 12 P 99.

It will be seen that an agreement to share profits only, can constitute in law, a partnership between the parties to the agreement."

Samarakoon C.J. in *Davoodbhoy v. C.G.I.R.* S.C. 9/79.

Question will arise whether the profits of the sub-partnership could be divided among the partners of the sub-partnership. The agreement to share the profits and losses is enforceable by the sub-partners and the profits accrue to the benefit of the sub-partners, and profits must therefore be divided among such partners.

"The question then arises whether the interest of the sub-partnership in the profits received from the main partnership is of such nature as diverts the income from the original partner to the sub-partnership. Suppose that A is carrying on a business as a sole proprietor and he takes another person B as a partner. There is no doubt that the income derived by A after the date of the partnership cannot be treated as his income; it must be treated as the income of the partnership consisting of A and B. What difference does it make in principle where A is not carrying on a business as a sole proprietor but as one of the partners in a firm? There is no doubt that there is this difference that the partners of the sub-partnership do not become partners of the original partnership. This is because the law of partnership does not permit a partner, unless there is an agreement to the contrary, to bring strangers into the firm as partners. But as far as the partner himself is concerned after the deed of agreement of sub-partnership, he cannot treat the income as his own. Prior to the case of *Cox v. Hickman* (1860) 8 H.L. Cas. 268, sub-partners were even liable to the creditors of the original partnership. Be that as it may, and whether he is treated as an assignee within section 29 of the Indian Partnership Act, as some cases do, a sub-partner has definite enforceable rights to claim a share in the profits accrued to or received by the partner."

In *Murlidhar Hiwatsingka and another v. C.I.T. Calcutta* (1966) 62 ITR 323.

It was held in the case of *C.I.T. v. Savundranayagam* 1 CTC 493, that, it is open to the Assessor to hold, if the facts warrant it, that a company or a partnership would be considered, for purposes of income tax, as artificial or fictitious ...... although as far as parties are concerned, there is a legal basis for such company or partnership. Again in the case of *C.I.T. v. A. H. M. Allaudin*, 1 CTC 440 it was held that profits of a *de facto* partnership the initial capital of which exceeded Rs. 1,000, an Assessor was not precluded by the evidentiary prohibition contained in section 18(c) of the Prevention of Frauds Ordinance, from proving that although there was no written agreement or partnership in operation, a *de facto* partnership subsisted and that a particular person, who had managed the business and who had been paid a monthly allowance as well as a share of the profits of the business was in truth a partner, and not merely an employee of the business.

The existence of an agreement or the registration of the partnership under the Business Registration Ordinance will not conclusively prove the existence of a valid partnership. It is therefore, *prima facie* a question entirely of fact whether or not a partnership exists. In Lindley on Partnership the learned author observed that "it is the carrying on of the business, not an agreement to carry on that business, which is the test of partnership."

The minority of a partner is no bar to the existence of a partnership *(Ebrahimjee v. C.I.T.* 1 CTC 351). A minor is not bound by a contract of partnership made by him during his minority; but if he agrees with adults to be their partner and subsequently on behalf of the partnership enters into contracts with third persons, those contracts bind his adult partners and they are entitled to insist that the partnership assets shall be applied in payment of the partnership liabilities before he received anything *(Nagoor Meera v. Meera Saibo;* 1919 6 Ceylon Weekly Reporter 89 at 91)

1. **Relations of Agency.**

This is one of the important considerations to decide whether or not a partnership is in existence, in that whether the person who purports to constitute it can bind each other and the firm in transactions with the outside world. The element of agency must clearly indicate an inherent right to conclude transactions on behalf of the firm without any form of authority delegated or otherwise. The position of each person claiming to be partners must be examined and evidence sought as to whether a partner could order goods, negotiate sale, conclude contracts, engage or dismiss staff independently without the express authority of other partners in the partnership. A person who takes an active part in the general control and management of the business would normally be held out as a partner and be accepted by others as such. If it is found that a manager employed by the partnership is in a position to conclude arrangements with persons who are actually outside the partnership such arrangement is on the basis of a delegated authority and must be distinguished with the absolute authority of the partner.

2. **Community of Profits and Losses**

This is also one of the important considerations and it is of the essence of partnership that the persons acting together in concert are carrying on business in common with a view to sharing of profits or losses would be a *prima facie* evidence, but it does not make the persons sharing profit partners of a business. For instance where an employee is paid a share of the profits of the business, or a widow or child of a deceased partner received a share of the profits or a seller of the business is repaid by a share of the profits, all these will not amount to sharing of profits and constitute evidence of the existence of a partnership.

A salaried partner who is entitled to a fixed predetermined share of the profits may not in all circumstances be regarded as a partner. However, where it is found that such a salaried partner is recognised as an agent capable of binding his co-partners and can conclude binding contracts with the outside world without any delegated authority, then such a salaried partner would be regarded as a partner of that partnership business.

3. Other relevant facts

The contributions of the person claiming to be a partner to the capital of the firm and the sharing of the profits for his own use and enjoyment would be relevant evidence as to the existence of a partnership. Facilities enabling partners to draw on profits when appropriate and the requirement that any two partners should sign cheques would be added evidence pointing to the existence of partnership. Notification to creditors and interested parties of any evidence of any specific arrangement in connection with the dissolution of the partnership and for the distribution of the partnership assets will also be relevant evidence in determining whether or not a partnership is in fact existing.

A partnership is the carrying on of the business in common with a view to profit and the existence of partnership must, therefore, be a question of fact. In the case of *Dickenson v. Gross,* 11 TC 614, it was held that since there was no community of interest in the profits and capital there was in fact no partnership, notwithstanding the fact that there was a deed of partnership. On the other hand, in *Fenton v. Johnstone,* 23 TC 29 where the parties agreed that their relationship should not constitute a partnership but having regard to the conduct of the parties, it was held that a partnership did in fact exist.

4. Duties and obligations of a Partnership

A Precedent Partner of a partnership shall be answerable for doing all such acts, matters, and things as would be required to be done under the income tax law. S. 145. However, where a person to whom a notice has been given as precedent partner shall be deemed to be a precedent partner unless he proves that he is not a partner in such partnership or that some other person resident in Sri Lanka is the precedent partner. S. 145(1).

Where a trade, business, profession or vocation is carried on in partnership, the precedent partner is required to:

(a) furnish a return of the partnership profits or losses in respect of any year of assessment showing.

  (i) any interest, annuity, ground rent or royalty payable by such partnership;

  (ii) any other income of the partnership for that year of assessment;

  (iii) the names and addresses of all partners and the apportionment among them of the divisible profit or losses and other income according to their profit sharing ratios taking into account in such apportionment the partners' salaries and interest on partners capital. S. 65(3).

(b) to give each partner a notice specifying his share of the divisible profits or loss and other income of the partnership in respect of an year of assessment on the form as may be specified by the Commissioner General. S. 65(4).

Where there is no active partner resident in Sri Lanka the return shall be furnished by the agent of the partnership in Sri Lanka. S. 65(3).

A Precedent Partner means the partner who, of the active partners resident in Sri Lanka:

(a) is first named in the agreement of partnership; or

(b) if there is no agreement, is specified by name or initials singly or with precedence to the other partners in the usual name of the partnership; or

(c) is the first named in the statement made under section 4 of the Business Names Ordinance. S. 163.

An Active Partner in relation to a partnership, means a partner who takes an active part in the control, management, or conduct of the trade or business of such partnership. S. 163.

5. **Notice by Precedent Partner to Partners.** S. 65(4).

A Precedent Partner of a partnership or where no active partner is resident in Sri Lanka, the agent in Sri Lanka of the partnership is required in respect of any year of assessment to issue to each partner a notice specifying his share of the divisible profit or loss and other income of the partnership Such notice shall be issued on or before the thirtieth of July, October, and January of that year of assessment and the thirtieth of September immediately succeeding that year of assessment. Such notice shall include any salary and other remuneration and any interest on partner's capital.

A partner who has not received such notice is, however, not absolved from the liability or the duty imposed on him to comply with the requirements of the Act by the reason that a notice from the precedent partner was not received by him.

6. **Computation of Partnership profits and losses.**

Where a trade, business, profession or vocation is carried on by one or more persons in partnership the statutory income from these sources are computed by applying the law and practice prevailing in determining such profits as one entity and apportioned among the partners. S. 65(5). In arriving at the divisible profits that are to be apportioned among the partners certain adjustments are required to be made. These adjustment are:

(a) deduction of interest, annuity, ground rent, or royalty by the partnership in respect of that business. No deductions can be made where it is payable by a person out of Sri Lanka to a person out of Sri Lanka. S. 65(2).

(d) no deduction can be made in respect of:

(i) salaries or other remuneration of partners; or

(ii) .interest on partners' capital.

These amounts will, however, be taken into account in apportioning the divisible profits or loss among the partners. S. 65(2).

The profits and income from other sources of income (i.e. other than trade, business, profession, or vocation) will be apportioned among the partners separately.

7. Profits and Income received by a spouse from a partnership

Instead of a person carrying on a business as a sole proprietor, he may consider a partnership with his spouse as a partner. In such an arrangement, the husband and wife will be assessed as separate individuals, each spouse will be entitled to a tax free allowance of Rs. 12,000 and would benefit by the reduction in tax when the profits are divided in a progressive tax rate structure for an individual.

A partnership between a husband and wife should have all attributes of a partnership to establish that a genuine partnership exists. Partnership by definition is "the relationship which subsists between persons carrying on a business in common with a view to profit. A partnership relationship can be established where partners meet from time to time to confirm acts of partnership which are carried on by any of the other partners. Where it is possible to establish a partnership between a husband and wife the profits of the partnership can be divided in the agreed profit sharing ratio and would be chargeable with tax individually on their share of profits.

However, in the case of profits and income received by one spouse for services rendered in any trade, business, profession or vocation carried on or exercised by a partnership of which that other spouse is a partner shall be deemed to be profits and income of that other spouse. S. 23(6). With the exception of payments to a spouse for services rendered, it would appear that where the spouses carry on business in common the profits can be divided and chargeable with tax separately.

8. Value of interest in the partnership.

The value of interest of a partner in a partnership should be included in the wealth of such partner. S. 44(g).

Example

The profit and loss account and the balance sheet of the firm of partnership of Messrs. Perera and Silva are as follows:

Balance Sheet as at 31.03.1982

	Rs.	Rs.		Rs.
Share capital			Land & buildings ...	... 100,000
Perera	50,000		Stocks	... 50,000
Silva	50,000	100,000	Debtors	... 20,000
Current Account Mr. Perera	...	25,000	Cash	... 20,000
Loan from Mr. Perera ...	...	100,000	Current Account Mr. Silva	... 15,000
Sundry Creditors ...	...	10,000	Shares in companies ...	... 30,000
		235,000		235,000

Trading, Profit and Loss Account

Stock as at 31.03.1981 ...	...	45,000	Sales	... 200,000
Purchases	...	120,000		
		165,000		
Stock as at 31.03.1982 ...	50,000			
Cost of sales ...	...	115,000		
Gross profit ...	...	85,000		
		200,000		2000,000

Partner's salaries			Gross profits	...	...	85,000
Mr. Perera ...	12,000		Dividends (net)	...	...	6,000
Mr. Silva	10,000	22,000				
Salaries & wages		21,000				
Ground rent		4,000				
Interest on loan from Mr. Perera ...		12,000				
Interest on capital: Mr. Perera	6,000					
Mr. Silva	6,000	12,000				
Net Profits: Mr. Perera ...	10,000					
Mr. Silva ...	10,000	20,000				
		91,000				91,000

The value of the assets of the partnership business has been agreed with the Assessor as representing market value at the balance sheet date. There is no goodwill of the partnership.

Computation of Divisible Profits	Rs.	Rs.	Rs.
Net Profits as per accounts			20,000
Add: Partners' salaries		22,000	
Interest on partners' capital		12,000	
Ground rent		4,000	38,000
			58,000
Less: Dividends			6,000
Statutory Income			52,000
Less: Ground rent			4,000
Divisible Profits			48,000
Profits apportioned as follows:		Mr. Perera	Mr. Silva
Share of divisible profits		7,000	7,000
Salary		12,000	10,000
Interest on capital		6,000	6,000
Share of partnership profits		25,000	25,000
Dividends (gross)		3,750	3,750
Tax credit on dividends		(750)	(750)
Computation of interest in the Partnership			
Share capital		50,000	50,000
Current Account		25,000	(15,000)
Value of interest in partnership		75,000	35,000

9. Partnership Losses

Partnership losses are determined in the same manner as the determination of profits. The amount of any ground rent, interest, annuity or royalty is added to the total loss to arrive at the divisible loss. Any sum paid as partner's salary or interest on partners' capital will be taken into account in determining the divisible loss.

10. Non -Resident Partner. S. 65(6).

The income of any non-resident partner is assessable either:

(i) in the name of the partnership; or

(ii) in the name of any resident partner; or

(iii) on any agent of the non-resident partner or partnership in Sri Lanka.

The tax payable can be recovered out of the assets of the partnership or from any partner or from any agent of such non-resident partner.

11. Assessment on the Partnership

Partnership is not a legal person and therefore no assessments are made on the partnership in respect of the profits of the partnership; the share of the divisible profits are assessed on the individual partners. However, an assessment in the name of the partnership can be made in the following circumstances. S. 66(1).

(a) where no return has been made by the partnership;

(b) the return has not been accepted by the Assessor either as regards profits or income or the allocation amongst partners.

It is lawful for an assessment to be made in the name of the partnership on an estimated amount of the profits or income of such partnership. Tax chargeable on such an assessment is 30 %. The tax charged on the partnership is recoverable out of the assets of the partnership or from any partner or from any agent of the partnership.

Any person aggrieved by such an assessment may appeal to the Commissioner General of Inland Revenue or to the Board of Review and upon determintation the profits can be allocated among the partners and the income tax payable may be reassessed on the individual partners or can be recovered without any new assessment. S. 66(1).

Where an assessment has been made in the name of the partnership and a change occurs in such partnership by reason of retirement or death, or the dissolution of the partnership as to one or more of the partners, in such circumstances that one or more of the persons who were partners continues to own the assets of the partnership the new owners or partnership is chargeable on any part of the unpaid tax. S. 66(2).

12. Statutory Income of a Partner. S. 65(5).

The statutory income of a partner in a partnership is the share of his divisable profits computed in accordance with the law and practice prevailing. The divisible loss of the partner is similarly computed in accordance with the law and practice prevailing.

Where no return has been made by a partnership or where the return furnished has not been accepted. the Assessor may estimate the statutory income of any partner from the partnership or the share of any partner of any divisible loss of the partnership to the best of his judgement.

Where an Assessor is of opinion that the whole or a part of the divisible profits of the partnership has been appropriated by a partner, the Assessor may include in that partner's share of the divisible profits of the partnership the appropriated profit by that partner, and the statutory income of such partner is computed on that basis.

13. Assessment in the name of the partnership.

The Partnership firm is not an entity for taxing purposes or for any other purpose, its name being simply a convenient way of describing the persons who consitute the firm. In the case of *Harrison v. Willis Bros.*, 43 TC 61, the Master of Rolls said:

"The provision that the assessment is to be made 'in the partnership name' is machinery by which these persons are designated who were partners during the year when the profits were made. They are still to be designated by that name even after the partnership is dissolved."

The question arises as to the position where one of the partner dies. The Master of Rolls said:

"It appears to me that when two or more persons are jointly chargeable to tax (as in the case of partners) and one dies, the assessment for the year whilst they were partners must still be made in the partnership name, but it is assessment which imposes a liability on the survivors and not on the dead man or his executors, When the survivors are reduced to one, the assessment for the year when they were partners must still be made in the name of the partnership, but it is liability on the last survivor alone. After the last survivor dies, the assessment must still be made in the partnership name--but it is assessment which imposes liability on the executor or the administrator of the last survivor. In any such cases, of course, when a surviving partner is made liable, he may be able to obtain a contribution from the estate of the deceased partner. But that is no concern of Revenue. The Revenue must make the assessment in the partnership name and impose a liability on the survivor, as I have said, and not on the executor of the deceased person".

14. **Collection and Recovery of Tax from a partner.** S. 133.

Any unpaid tax attributable to the share of the divisible profits of a partnership of a partner may be recovered out of the assets of the partnership which for this purpose is deemed to be the assets of the partner.

Any sum recovered out of the assets of the partnership in respect of the tax in default of any partner shall not exceed the interest of such partner in the partnership.

Chapter 10

CLUBS AND TRADE ASSOCIATIONS

Clubs and trade associations are bodies of persons and are liable to income tax on their profits or income. Basically, in the case of clubs and trade associations where the members are entitled to participate in the surplus, there would be mutuality and it cannot be said to be carrying on any trade or business, for no man can trade with himself.

"It is a fallacy ...... to say in the case of such a club that where a member orders a dinner and consumes it, there is any sale to him ...... There is not a sale. The fundamental thing that the whole property is vested in the members ...... The members have a right to participate in the whole ...... There is ...... no trade among the members. They cannot trade with themselves."

Finlay J., in the case of *National Association of Local Government Officer v. Watkins;* 18 TC 499.

Where a club is a proprietory club, in that it is not owned by members themselves, the proprietor is carrying on business and there would be no element of mutuality *(I.R.C. v. Ecentric Club Ltd.,* 12 TC 657).

A club or a trade association is deemed, in certain circumstances, to carry on business. S. 90(1) & (2); Where a trade association is deemed to carry on business, the liability to income tax will be either on its business profits or the investment income, whichever is greater. Where a trade association is not deemed to carry on business, the liability to income tax will be on the investment income. A club will be liable on its investment income and on its profits from any business such a club is deemed to carry on.

1. Basis of liability of a club

A club or similar institution is liable to income tax on its investment income and its business income where such a club is deemed to carry on business. S. 90(1).

2. Investment income of a club

A club is not deemed to carry on business where it receives from its members not less than three fourths of its gross receipts on revenue account including entrance fees and subscriptions. It will then be liable on its non-business income, that is, investment income. The sources of investment income would be:

(a) Income from property, that is, rent and net annual value of property;

(b) Dividends;

(c) Interest.,

3. **Business income of the club**

A club is deemed to carry on business where it received less than three fourths of its gross receipts from members, including entrance fees and subscriptions.

Where the club is deemed to carry on business, it will be liable on both:

(a) ITS BUSINESS PROFITS computed in accordance with the income tax law. In computing the profits of the business of a club, the whole of the income from transactions, both with members and others including entrance fees and subscriptions is deemed to be receipts from a business; and

(b) ITS INVESTMENT INCOME. The investment income of a club would be rent, net annual value of its property, interest, dividends etc.

4. **Gross receipts on revenue account**

The gross receipts from the members on revenue account of a club will include the following:

(a) Entrance fees;
(b) Subscriptions;
(c) Donations from members;
(d) any other receipts from members.

In determining whether a club is carrying on business, the gross receipts from members of the club from the above transactions will be taken into account.

5. **Income from transactions with members and others.**

Where a club is deemed to carry on business, the whole of the income from transactions both with members and others, including entrance fees and subscriptions will be deemed to be receipts from a business. The following would be receipts from a business of a club:

(a) entrance fees;
(b) subscriptions;
(c) Where the club is carrying on business, profits from that business;
(d) Gains resulting from sale of investments of the club;
(e) Profits made by the club in respect of fund-raising activities like benefit shows, carnivals, sale of sweep tickets etc.

The following receipts of a club do not arise from transactions with members and others:-

(a) donations received from members and others by the club;
(b) investment income, i.e. interest, dividends, rents etc.

In computing the business profits of the club all outgoing and expenses (other than expenses which are prohibited from deduction) can be deducted.

6. **Basis of liability of trade associations.** S. 90(2).

A trade association, a chamber of commerce or similar institution is liable to income tax either on its:

(a) business income; or
(b) investment income.

WHICHEVER IS GREATER.

7. Business income of a trade association. S. 90(2).

A trade association is deemed to carry on business where more than half its receipts by way of entrance fees and subscriptions are from persons who claim or would be entitled to claim such as deductions in computing their profits.

Where the trade association is deemed to carry on business, it will be liable on the higher amount of either:

(a) BUSINESS INCOME computed in accordance with the provisions of the tax law. In computing the profits of the business of a trade association, the whole of the income from transactions both with members and others, including entrance fees and subscriptions is deemed to be receipts from a business. *OR*

(b) INVESTMENT INCOME. The investment income of the trade association would cover interest, dividends, rent, net annual value of property owned by the trade association.

8. Members in relation to a Club or Trade Association

Members in relation to a body of persons means those persons who are entitled to vote at a general meeting of the body at which effective control is exercised over its affairs. S. 90(3). Thus in order to determine whether the club or trade association is carrying on business the gross receipts on revenue account from members who are entitled to vote at the general meeting of such club or trade association will only be taken into account.

Example:

The income and expenditure of the Excellsor Club for the year ended 31.3.1982 is as follows –

Income	Rs.	Expenditure	Rs.
Balance brought forward.:		Office Salaries	10,000
Cash and Bank on 1.4.1981 ...	12,000	Rent and Rates	5,000
Subscriptions	12,000	Postage and Stationery	2,500
Entrance fees	3,000	Office Equipment	10,000
Donations from Members ...	8,000	Upkeep of Furniture etc. ...	500
Profits from Benefit Show ...	9,000	Telephone	1,000
Liquor Sales	5,000	Audit and Accountancy Fees ...	1,000
Interest	9,000	Donations	10,000
Donations from Others	25,000	New Year Gifts to Poor Children ...	5,000
Dividends (gross)	9,000	Balance in Hand:	
Capital Gains on Sale of Shares ...	1,000	Cash and Bank as at 31.3.1982 ...	48,000
	93,000		93,000

Office Equipment bought during the year were:

One Typewriter	Rs. 4,000
One Steel Cabihet	Rs. 6,000
	Rs. 10,000

Donation made during the year were to the Ceylon Cancer Society.

Computation of liability to income tax for the year of assessment 1981/82.

(i) Determine whether the club is carrying on business

Gross receipts from members:

Subscriptions	Rs. 12,000
Enterance Fees	3,000
Donation from Members	8,000
Gross receipts from Members	Rs 23,000

Gross receipts of the club from members and others	Rs.	81,000
Three fourths thereof		60,750

Therefore the club is deemed to carry on business.

(ii) **Investement income of the club**

Interest	Rs.	9,000
Dividends (gross)		9,000
Total Investment Income		18,000

(iii) **Computation of the business income of the club**

Cash and Bank balance as at 31.03.1982			Rs.	48,000
Add: Office Equipment	Rs.	10,000		
Donations		10,000		
New Year Gifts to Poor Children		5,000		25,000
				73,000
Less: Donations from Members ...	Rs.	8,000		
Donations from others		25,000		
Interest		9,000		
Dividends		9,000		
Capital Allowances for Equipment		1,250		52,250
Adjusted Business Profits of the Club				20,750

(iv) **Calculation of income tax liability**

The club will be liable to income tax both on the investment income and the business income

Interest...	Rs.	9,000
Dividends		9,000
Business Profits		20,750
Taxable Income	Rs.	38,750
Tax at 20%	Rs.	7,750
Less: Credit for Tax deducted on Dividends		1,800
Tax Payable	Rs.	5,950

9. Business Loss of a Club or Trade Association

A club or trade association may incur loss from the business it is deemed to carry on. A club or trade association will be liable to income tax, despite the loss on business income, if such club or trade association has any investment income in that year.

Since statutory loss has been determined, such loss can be carried forward and set off against future business income of the club or trade association. A business loss cannot be set off against the investment income of the club or trade association.

10. Sports Clubs. S. 12(1) (d)

The net annual value of the premises owned and occupied by a Sports Club is exempt from income tax. The Sports Club will be liable to income tax on any income from rent of the premises.

In order to quality for exemption from income on the net annual value, the Sports Club must satisfy the following:–

(a) The primary object of the Club must be the promotion of any sport which is a recognised sports for the purposes of the Sports Law No. 25 of 1973.

(b) The premises must be for the objective of the promotion of any sport specified in the Sports Law No. 25 of 1973 by that club.

Chapter 11

LIABILITY OF NON-RESIDENT PERSONS

A non-resident person is liable to income tax on the profits and income arising in or derived from, Sri Lanka. *S.2.* Profits and income arising in or derived from Sri Lanka include profits and income from:

(i) Services rendered in Sri Lanka;
(ii) property in Sri Lanka; and
(iii) business transacted in Sri Lanka, whether directly or through an agent. S. 2(2).
(iv) Interest and Royalties which are deemed to be profits and income arising in or derived from Sri Lanka; S. 80A and 80B.[1]

"The word 'derive' implies that the source of the profits or income must be from Ceylon. If the local Government can reach the income derived by an agent in England on behalf of a person resident in Ceylon by the latter, such income may possibly be said to be derived from Ceylon. In my opinion these two words 'arise' and 'derive' were meant to include the case of the Ceylon Company when it makes any profits or gets any income for anything done in Ceylon and the case of a non-resident owner deriving his income from an estate in Ceylon".

Akbar J. in *Anglo-Persian Oil Co, Ltd. v. C.I.T.* 1 CTC 82 at page 88.

1. **Profits and income from services rendered in Sri Lanka.**

The profits of a non-resident person from employment by a resident person is liable to income tax in so far as such profits arise from services or past services rendered in Sri Lanka. S. 72.

Profits and income from services rendered in Sri Lanka can be from the exercise of profession, vocation or employment.

An indivudual who is not a citizen of Sri Lanka and who is employed in Sri Lanka is deemed to be a non-resident individual for a period of three years from the date of commencement of his employment in Sri Lanka, S. 67(7).[2] Such non-citizen employee will be liable only on his profits and income derived from Sri Lanka during the period in which he is deemed to be a non-resident individual.

2. **Profits and income from property in Sri Lanka.**

Profits and income arising out of any movable or immovable property in Sri Lanka will be liable to income tax in the hands of a non-resident person. Profits arising in or derived from property in Sri Lanka will include income from rent, interest, dividends from companies, etc.

---

1 40 of 1981 2 24 of 1980

"We next come to profits and income derived from property in Ceylon. I consider this to mean that profits are taxable if they arise out of some immovable property situate in Ceylon such as tea or rubber estate, or as the result of trade connected with commodities or products manufactured or grown in Ceylon."

Koch J., in *Anglo Persian Oil Co. Ltd., v. CIT.* 1 CTC 82.

3. **Profits and income from business transacted in Sri Lanka.**

A non-resident person is liable on the profits and income derived from business transacted in Sri Lanka whether directly or through an agent. In interpreting the meaning of the words "business transacted in Sri Lanka" the courts were guided by the decisions in the English courts on their interpretation of the words 'trade exercised within the United Kingdom'.

"The language of our Ordinance is much more similar in substance to that of the New Zealand Act, and therefore while the opinion of the Privy Council in the New Zealand case *CIT v. Lovell & Christmas Ltd.* 1908 Privy Council A. C. 46 on the law would apply in its full intensity to Ceylon, the authoritative English decisions as to the principles to be applied to the interpretation of the words "from any trade exercised within the United Kingdom" will also apply to the interpretation of the words of our Ordinance namely, "from a business transacted in Ceylon".

Koch J., in *Anglo-Persian Oil Co. Ltd. v. CIT.* 1 CTC 82.

The important rule to decide whether business is transacted in Sri Lanka is to determine the place where the contract has been made. This rule was laid down in *Erichsen v. Last* 1 TC 351 by Lord Brett L. J.

"Whenever profitable contracts are habitually made in England, by or for foreigners, with persons in England, because they are in England to do something for or supply something to those persons such foreigners are exercising a profitable trade in England even though everything to be done by them in order to fulfill the contracts is done abroad."

The courts have generally laid down three essential considerations to determine the place where the business is transacted. These are:

(a) the place where the contract is made;
(b) the place where the delivery was to be made;
(c) the place where the price was to be paid.

The most important of these tests is the test as to the place where the contract is made. This was laid down in *Maclaine v. Ecott*; 10 TC 481, by Lord Chancellor:

"The question whether a trade is exercised in the United Kingdom is a question of fact, and it is undesirable to attempt to lay down any exhaustive test of what constitutes such an exercise of trade: but I think it must now be taken as established that in the case of a merchant's business, the primary object of which is to sell goods at a profit, the trade is exercised or carried on at the place where the contracts are made."

In *Grainger v. Gough* 3 TC 462, this rule was applied and it was held that where the contracts are made outside United Kingdom, there is no liability to tax. In this case the trade carried on was held to be with England and not within England.

Thus if a person in Sri Lanka buys goods direct from a person in another country the person in the foreign country is trading with Sri Lanka and will not be liable to Sri Lanka tax. On the other hand if a foreign merchant had a branch in Sri Lanka to which goods were consigned and that branch sold goods to the resident person the foreign merchant is exercising trade within Sri Lanka and will be liable to Sri Lanka Income Tax.

4. **Interest and Royalties which are deemed to be profits and income arising in or derived from Sri Lanka.**

Interest on certain loans and certain royalties are deemed to be profits and income arising in or derived from Sri Lanka in the following circumstances.

(a) *Interest on loans obtained from a Non-resident.* S. 80A.[1]

(i) Where the interest on such loan is borne directly or indirectly by a person resident in Sri Lanka; or

(ii) Where the Non-Resident person has borne interest on the whole or part of any loan brought to or used in Sri Lanka.

(b) **Royalties. S. 80B**[1]

(i) the royalty payment is borne directly or indirectly by a person resident in Sri Lanka; or

(ii) Where such royalty payments are payments which any person could claim as deduction from his statutory income in computing his assessable income.

Deduction in respect of any sum payable as royalty by a person out of Sri Lanka to another person out of Sri Lanka is not allowed in computing the assessable income of any person. S. 29(2) (a).

5. **Contracts and sale outside Sri Lanka.**

It is provided that 'where a person in Sri Lanka acting on behalf of a non-resident person, effects or is instrumental in effecting any insurance or sells or disposes of or is instrumental in selling or disposing of any property, whether such property is in Sri Lanka or is to be brought into Sri Lanka and whether the insurance, sale or disposal is effected by such person in Sri Lanka or by or on behalf of the non-resident outside Sri Lanka and whether the moneys arising therefrom are paid to or received by the non-resident person directly or otherwise, the profits arising from any such insurance, sale, or disposal shall be deemed to be derived by the non-resident person from business transacted by him in Sri Lanka, and the person in Sri Lanka who acts on his behalf shall be deemed to be his agent for all the purposes of the Act.' S. 68.[1]

The effect of this provision is to bring into liability non-resident persons acting through agents in Sri Lanka selling property in Sri Lanka although legally all the transactions are made outside Sri Lanka. The agent in Sri Lanka must be instrumental in bringing about the contract of sale or disposal of property or effects an insurance. In the case of *Chivers & Sons Ltd. v. CIT.* 1 CTC 110; where the firm in Sri Lanka was acting on behalf of the non-resident company by stocking, and displaying and keeping samples of goods of

1 40 of 1981

that company canvassed orders for goods and received commission on such orders made; this non-resident company was held liable on the profits on the sale of the goods in Sri Lanka, as profits arose from business transacted in Sri Lanka. Thus the profits arising in or derived from Sri Lanka will include all profits from the sale of goods where such sale has been brought about through the instrumentality of a person in Sri Lanka acting on behalf of the seller who is outside Sri Lanka, and in spite of the fact that legally the transactions of the business or the sale take place outside Sri Lanka.

6. Instrumental in selling or disposing.

If an agent in Sri Lanka did not actually effect the contract, or if he was not instrumental in effecting it, the non-resident would not be liable on the profits arising on the contract. The non-resident person in such event will be trading with Sri Lanka, directly with the trader in Sri Lanka. The words 'instrumental in selling' was examined by Koch J. in the case of *Anglo-Persian Oil Co. Ltd. v. CIT.* 1 CTC 82; He said

> "I am of opinion that the words 'instrumental in selling' means aiding or assisting in 'bringing about' the contract of such sale, which but for such aid and assistance may never have come off. A very apt illustration of this may be negotiations on the part of the agent in Sri Lanka carried out in Sri Lanka that have led to the making of the contract of sale of property in Sri Lanka, or to be brought into Sri Lanka, between the principals, both of whom may be resident outside."

The words 'sells or disposes' does not include mere delivery of property which happens to be in Sri Lanka irrespective of the fact of it being sent here for the purpose of delivery to a party who was to accept it under an agreement entered into abroad. Thus in the case of *Anglo-Persian Oil Co. Ltd. v. CIT.* 1 CTC 82, the company entered into contract in London for the sale of fuel oil to shipowners, whose ships call at Colombo. The delivery of the oil was to be made by the agent of the company who stores his oil as well as the oil of the company, payment being made in London on receipt of the telegraphic advice of the quantity of oil delivered. The shipowners were bound to purchase all their requirements of oil from the company, who undertook to keep sufficient oil to satisfy their requirement. It was held that the company was not liable as the contract was not made in Sri Lanka and the agent in Sri Lanka was not instrumental in bringing about the contract. Akbar J. said:

> "The sale or disposal when it refers to the person in Sri Lanka, means in my opinion, a sale or disposal by the person in Sri Lanka on behalf of his foreign principal as a definite legal act and does not include a mere delivery by an agent in Sri Lanka of goods sold in pursuance of a contract made outside Sri Lanka."

7. Determination of profits of a non-resident manufacturer.

The proviso of section 68[1] sets a limitation of the amount of the profits liable to income tax in the hands of the non-resident manufacturer who sells his produce in Sri Lanka. The limitations are:

---

1. 40 of 1981

(i) if the sale is by wholesale the profits shall not exceed the profits which might reasonably be expected to be made by a merchant selling the property wholesale; and

(ii) if the sale is by retail, the profit shall not exceed the profit which might reasonably be expected to be made by a merchant selling retail.

Although the Commissioner General has the power under section 70 to compute the profits arising from business carried on by a non-resident person which cannot be readily ascertained, as a percentage of the turnover, such estimated percentage cannot exceed the ceiling placed.

"The provision of section 34 states that in taxing a non-resident manufacturer of goods who sells such goods in Ceylon the profits shall "be deemed to be not more than the profits which might reasonably be expected to be made by a merchant selling the property wholesale" we are of the view that in such case a ceiling on the profits has been placed beyond which he cannot be taxed."

Thambiah J. in *J. A. P. Zebedde Fernando & Co. v. CIR.* 3 CTC. at page 83. The provision of section 34 of Income Tax Ordinance is similar to the provisions of section 68 of the Inland Revenue Act No 28 of 1979.

The merchant selling wholesale is any merchant selling wholesale – Thambiah J. in *Zebedde Fernando & Co.* in CTC 85.

"We are of the view that where a person in Ceylon sells or disposes of any property wholesale by or on behalf of a non-resident outside Ceylon, who manufactures such goods, the provision to section. 34. applies and for the purpose of income tax the profits of such sale or disposal are deemed to be not more than the profits which might reasonably be expected by the merchant selling the property wholesale in Ceylon. The words "a merchant" mean any merchant belonging to the category set out in the proviso to section 34. The merchant contemplated in the proviso is not a merchant who buys from a non-resident manufacturer and sells commodity in Ceylon, but any merchant who sells it by wholesale in Ceylon."

The word merchant means any merchant selling wholesale or retail in Sri Lanka and not a merchant who buys from a non-resident manufacturer and sells the commodity in Sri Lanka. In the case of an agent of non-resident manufacturer it was held that he was liable to tax on the basis of profits that any wholesale merchant might reasonably be expected to make; *J. A. P. Zebedde Fernando v. CIR.* 3 CTC 74.

Where import duty has been paid at an add valorem basis on any goods or produce, the sum to be deducted as cost for purpose of computing profits shall not be greater that the value on which import duty was paid. S. 69 (3).

8. Non-resident person trading with a resident person who is closely connected

Where a non-resident person and the resident person are closely connected their affairs may be so arranged that it produces to the resident person either no profits or less than the profits which might be expected to arise in the normal course of trading. In such an event the non-resident person is assessable and chargeable with income tax in respect of any profits evaded by such arrangement in the name of the resident person, as if such non-resident person was carrying on business in Sri Lanka. Such an assessment is made where it can be established that:

(i) the non-resident person and the resident person are closely connected;

(ii) that there is some arrangement between them which results in either no profits or less than the profits ordinarily expected to arise to a merchant in Sri Lanka.

(iii) the profits disclosed is less than the profits of a wholesale or retail merchant in the similar line of business in Sri Lanka.

A person is 'closely connected' with another person where the Commissioner General considers that such persons are substantially identical or that the ultimate controlling interest of each is owned or deemed to be owned by the same person or persons. S. 69(1) (b). The controlling interest of a company is deemed to be owned by the beneficial owners of its shares, whether held directly or 'through nominees. S. 69(1) (b). The effect of the provision is to prevent evasion of income tax by a non-resident person by overstating the price at which the goods are sold to the resident person so that the resident person makes no profits or less than the profits that would have been made by a merchant.

Where it is established that the non-resident and the resident persons are closely connected, the profits assessable shall not be less than the profits which might reasonably be expected to have been made by a merchant, who bought the same direct from a manufacturer or producer with whom he was not closely connected. S. 69(3).

9. Commissioner General to compute the profits as a percentage of the turnover where the profits cannot be readily ascertainable. S. 70

Where the Commissioner General considers that the true amount of the profits of a non-resident person arising from Sri Lanka in respect of any business cannot be readily ascertained, he may compute the profits on a fair percentage of the turnover of that trade. This is an arbitary provision and any person aggrieved can question the basis of the percentage adopted on appeal. Although the Commissioner General has the power to compute the profits as a percentage of the turnover, in respect of the business carried on in Sri Lanka by a non-resident person, whose profits cannot be readily ascertained, he cannot overide the limitation that the profits assessable on the non-resident person is the profits which might reasonably expected to be made by a merchant selling wholesale or retail: S. 68[1] Proviso.

10. Profits of non-resident persons from sale of exported produce. S. 71.

Profits assessable on a non-resident person who carries on in Sri Lanka any agricultural, manufacturing or other productive undertaking and sells the produce outside Sri Lanka, will be the full profits arising from the sale of the product in a wholesale market. If the profits have increased due to the

1. 40 of 1981

treatment of the product outside Sri Lanka, other than handling, blending, sorting, packing and disposal, such an increase in profits will not be considered as profits arising from the export of the product. Where the exported produce is not sold, the exporter is deemed to have made profit which might have been obtained if sold in the wholesale market to the best advantage.

11. **Exemption of income of non-resident persons in certain cases.** S. 75(2).

(i) **Dividends, interest, annuity, ground rent or royalty.**

Where a non-resident person receives any dividend from a non-resident company or any sum by way of interest, annuity, ground rent or royalty which is payable to him by a person out of Sri Lanka is exempt from income tax. S. 73 (2). Such person is also not entitled to any repayment.

(ii) **Interest from Treasury Bills.**

Any sum received by a non-resident person as profits or income arising from any Treasury Bills is exempt from income tax. S. 73(3).

However, where such sums are received by a non-resident person in the course of carrying on a trade or business the non-resident person will be liable to income tax. S. 73 (4).

12. **Royalty payable by a non-resident person to a company which has entered into an agreement with the Greater Colombo Economic Commission.** S. 73(5).

The rate of income tax chargeable on royalties received shall not exceed the rate, if any, specified in that agreement as the rate at which income tax is deductible from that royalty.

13. **Exemption of interest income of certain non-resident persons.** S. 10(c).

Interest income accruing to any partnership, company, or other body of persons outside Sri Lanka from any loans granted to:

(a) the Government of Sri Lanka;
(b) any public Corporation;
(c) any government institution;
(d) any commercial bank operating in Sri Lanka;
(e) to any other undertaking if such loan is approved by the Minister of Finance as essential for the economic progress of Sri Lanka.

14. **Exemption of profits and income of non-resident contractors.** S. 22.

A non-resident person is exempt from income tax in respect of the profits arising from contracts entered into by him prior to November 12, 1981 with:

(a) the Government of Sri Lanka;
(b) a statutory corporation or institution which is approved by the Minister of Finance for the purpose of the exemption; or

1 27 of 1982.

(c) a proprietor of any undertaking for the construction of a hotel which will be entitled to exemption from income tax for a period of five years.

In order to be qualified for exemption the non-resident person must satisfy the following conditions:

(a) at the time he entered into such contract, was a non-resident person and did not have a place of business in Sri Lanka;
(b) the non-resident contractor satisfies the Commissioner General that he entered into such contract on the basis that the profits will be exempt from income tax.
(c) must be declared by the Minister of Finance as a person whose services are required for the economic development of Sri Lanka. Non-resident contractors who have been approved for the tax holiday prior to 12th November 1981 will continue to enjoy the exemption of profits from income tax.

15. **Persons assessable on behalf of a non-resident person.** S. 66.

A non-resident person is assessable either directly or in the name of his agent on all his profits and income arising in or derived from Sri Lanka whether such agent has the receipts of the profits or income or not. The income tax assessed is recoverable out of assets of the non-resident person or from the agent. Where there are more than one agent, they may be assessed jointly and severally and are jointly and severally liable for such tax.

16. **Non-resident Foreign Currency Accounts.** S. 10(e).

Interest accruing to any person on moneys lying to his credit in a non-resident foreign currency account opened with any Commercial Bank with the approval of the Central Bank of Ceylon is exempt from income tax during the period in which such person is not resident in Sri Lanka and for a period of three years from the date on which he ceases to be a non-resident. S. 10(e).

A non-resident foreign currency account can be opened by any person not resident in Sri Lanka with the approval of the Central Bank of Ceylon. A Sri Lankan can open such account within 90 days of his arrival in Sri Lanka and operate such account for a period of ten years thereafter.

17. **Rate of Income Tax on gross interest on loans granted by Companies, Partnership or a Body of Persons outside Sri Lanka.**

The gross interest, which is not exempt from income tax and which is deemed to arise in Sri Lanka to a Company, Partnership or a body of persons outside Sri Lanka on loans granted by them to any person in Sri Lanka is chargeable with income tax at fifteen percentum. S. 32 C.[1]

Interest income is deemed to be profits and income arising in or derived from Sri Lanka, where the interest is payable to a non-resident person on a loan obtained from such person and the interest on such loan is borne:

(a) directly or indirectly by a person resident in Sri Lanka; or
(b) by a non-resident person where the amount of such loan or part thereof has been brought to or used in Sri Lanka. S. 80A.[2]

1 27 of 1982 2 40 of 1981

Chapter 12

EXECUTOR OF THE ESTATE OF A DECEASED PERSON

Where an individual dies the liability of such deceased person will be determined on two basis:

(a) the liability up to the date of death; and
(b) the liability after the date of death.

1. **Liability up to the date of death.**

The liability of a deceased person up to the date of death is on the basis as if he were alive.

An Executor of the estate of a deceased person is liable to do all such acts, matters and things as such deceased person would be liable if he were alive. He will also be chargeable with income tax, wealth tax or gifts tax with which such deceased person would be chargeable if he were alive in respect of all periods prior to the date of death. S. 62.

An executor, cannot be charged with tax for any year of assessment in respect of a period prior to the date of such person's death, after the expiry of the third year of assessment subsequent to the year of assessment in which probate or letters of administration was issued to the executor. Where the non-assessment or under-assessment is by reason of fraud or wilful evasion or by reason of an incorrect statement by the executor, an assessment or additional assessment can be made at any time after the expiry of the third year of assessment. S. 62 Proviso (ii).

2. **Liability after date of death.**

A beneficiary is chargeable with income tax or wealth tax in respect of his share of the income or of the net wealth to which he is entitled from the estate of a deceased person. S. 63 (2).

Where the income or the net wealth to which a beneficiary is entitled from the estate of a deceased person cannot be ascertained, the executor shall be chargeable with income tax or wealth tax in respect of such income or wealth. S. 63 (4).

3. **Executor** S. 163.

An executor means an executor or administrator of a deceased person and includes:

(a) any person who takes possession of or intermeddles with the property of a deceased person;

(b) any person who has applied or is entitled to apply to a District Court for grant or resealing of probate or letters of administration in respect of the estate of the deceased person; or

(c) a trustee acting under a trust created by the last will of the author of the trust.

4. **Liability of the Executor** S. 62. Proviso (iii).

The liability of the executor is limited to the sum of;

(a) the deceased person's estate in his possession or control at the date when notice is given to him that liability to tax will arise; and

(b) any part of the estate which may have passed to a beneficiary.

The liability of the estate will not extend to the personal property of the executor provided that he has acted in good faith.

"If an executor ...... deliberately refuses to apply the assets of the estate in the payment of tax, there is no reason why the quasipenal provisions ... should not in the absence of express provisions to the contrary be available against him."

Fernando J., in *Puswella v. CIT.* 1 CTC. 564.

The position of the executor was examined further by Fernando J. in the same case (the relevant provisions are similar in the Inland Revenue Act).

"Having regard to section 27, which declares that an executor "shall be liable to do all acts, matters and things as the deceased person if he were alive would be liable ......", the executor is liable to pay the tax and would prima facie be a defaulter if he fails to make payment. The only seeming difficulty is that section 78 and 79 do not in terms exclude recourse to the personal assets of the defaulter in the case where he is an executor. But this difficulty would not arise if the expression "property of the defaulter" occurring in these sections is construed to mean "property of the defaulting executor, in his capacity as such" – a construction which is necessary having regard to the third provision of section 27."

No proceedings can be instituted against the executor in respect of any act or default of the deceased person. S. 62. Proviso (i).

Where tax which would have been payable by any person if he were alive is in default, the expression defaulter will mean;

(a) an executor or administrator of a deceased person; or

(b) any person who takes possession of, or intermeddles with the property of a deceased person; or

(c) any person who has applied or is entitled to apply to a District Court for the grant or resealing of a probate or letters of administration in respect of the estate of a deceased person. S. 131 (5).

5. **Chargeability of the Executor.**

An executor is chargeable with income tax, wealth tax or gifts tax with which a deceased person would have been liable if he were alive in respect of all periods to the date of the death of such person. S. 62

An executor will also be chargeable with income tax or wealth tax where the income or the net wealth to which a beneficiary is entitled from the estate of a deceased person cannot be ascertained. S. 63(4).

6. **Furnishing of returns.** S. 63(1).

An executor is required to furnish a return of income of the estate administered by him and the name and address of each beneficiary and his interest in such estate for the purposes of income tax. The executor must also send a return of the assets and liabilities of the estate administered by him and the names and addressess of the beneficiaries and their interest in, such estate for the purposes of wealth tax. S. 63(1).

Where the beneficiary is chargeable with income tax or wealth tax in respect of the share of income or net wealth to which he is entitled from the estate of the deceased person, the executor shall give notice on or, before the thirtieth day of July, October and January of that year of assessment and April of the succeeding year of assessment a notice stating the amount of income or net wealth. S. 63(3).

7. **Chargeability of the beneficiary.**

A beneficiary is chargeable with income tax or wealth tax in respect of his share of the income or of the net wealth to which he is entitled from the estate of the deceased person. S. 63 (2).

8. **Payment of Tax**

The income tax and wealth tax with which an executor is chargeable must be paid by him in four quarterly instalments to the Commissioner General of Inland Revenue under the Self Assessment Scheme, notwithstanding that no assessment has been made on him. S. 63 (5).

The income tax or the wealth tax or any part thereof with which a beneficiary is chargeable in respect of the income or net wealth to which he is entitled to from the estate of the deceased person can be recovered from the executor notwithstanding that no assessment has been made on him. The executor is entitled to deduct the amount of such tax or part thereof from the income which will be payable to such beneficiary from the estate of a deceased person. S. 136. Proviso of 125 (10).

9. **Tax payable deemed not in default. S. 125 (10).**

Where the executor of the estate of a deceased person satisfies the Commissioner General that he is unable to pay the tax or instalment of tax on or before the due date owing to probate or letters of administration not having been granted to him, such tax or instalment of tax shall be deemed not to be in default, if such tax is paid within two months after the date of the grant of probate or letters of administration. In cases where the executor has not been issued probate or letters of administration no penalty for late payment will be due, if the tax is paid within two months of the grant of probate or letters of administration.

However, in the case of any person who takes possession of, or intermeddles with the property of a deceased person, any tax due will be deemed to be in default. Such person is required to pay the tax or instalments on the due date and any unpaid tax will be deemed to be in default.

10. **Joint Executors.**

Where two of more persons act in the capacity of executors of a deceased person's estate, they may be charged jointly or severally with income tax, wealth tax or gifts tax with which they are chargeable and are jointly and severally liable for payment of such tax. S. 64.

11. Rate of Tax.

The rate of tax at which income tax is charged on the taxable income of an executor is 30%.

The rate of tax at which the taxable wealth of the executor is charged is as follows:

On the first	Rs.	200,000	– $\frac{1}{2}$%
On the next	Rs.	500,000	– $\frac{3}{4}$%
On the next	Rs.	1,000,000	– 1%
On the balance			– 2%

12. Indemnity of an Executor. S. 148

An executor from whom tax is recoverable in respect of the income or wealth of the estate of the deceased person may retain out of any assets coming into his possession or control in his capacity as executor, so much thereof sufficient to satisfy the amount of such tax, is indemnified against any person whomsoever in respect of such assets.

When any person acting as executor has paid tax and no assets of the estate have come to his possession or control out of which he could retain tax so paid, such tax is a debt due from the beneficiaries of the estate to the executor.

Chapter 13

CO-OPERATIVE SOCIETIES

A Co-operative society registered under the Co-operative Societies Law No: 5 of 1972 is a body corporate by the name under which it is registered with perpetual succession and common seal, and with power to hold property, to enter into contracts, to institute and defend suits and other legal proceedings and to do all things necessary for the purposes of its constitution (section 20 of Co-operative Societies Law No: 5 of 1972).

Co-operative societies which can be registered under the Co-operative Societies Law No: 5 of 1972 as contained in section 3 of that law are:

(a) a society which has as its objects the promotion of the economic, social or cultural interests of its members in accordance with the Co-operative principles; or

(b) a society established with the object of facilitating the operation of a society referred to in paragraph (a); or

(c) a society consisting of registered societies as members established for the purpose of providing Co-operative education and training, advisory services to Co-operative Societies in Sri Lanka and other services for the promotion of the Co-operative movement in Sri Lanka; or

(d) a society consisting of registered societies as members established for the purpose of planning, co-ordinating, and facilitating the activities of such Co-operative societies in Sri Lanka or any part thereof as are engaged in marketing, industry, agriculture, fisheries or in other activity as may be approved by the Registrar of Co-operative Societies.

Co-operative Societies are essentially mutual trading concerns and cannot be said to be carrying on trading activities in the tax law concept of 'trade'. Some of the Co-operative societies do however engage in trade with non-members to some extent.

1. Exemption of profits of Co-operative Societies

A Co-operative society registered under the Co-operative Societies Law No: 5 of 1972 in which the majority of the members are resident in Sri Lanka and the income of that society arising out of any business specified by the Minister of Finance by notice published in the Gazette is exempt from income tax.

In order to determine whether the majority of the members of the Co-operative society are resident in Sri Lanka in respect of a society which is a member of another society, each member of the first society will be deemed to be a member of the second society S. 8 (a) (xxvi).

The Minister of Finance has so far not specified the profits and income of any business of a co-operative society as exempt from income tax and therefore all co-operative societies would be liable to income tax on their profits and income.

In the case of co-operative societies carrying on business among its members only there would be mutuality as the members would be the properietors and at the same time customers. In such circumstance there would be no liability on the principle that no man can trade with himself.

Most of the multipurpose co-operative societies trade with non-members to some extent and in such case no mutuality will be present and the multipurpose co-operative societies will be liable to income tax.

2. Computation of Profits

The computation of profits for purpose of determining liability to income tax is approached in the same manner as would be applicable to a trading concern by applying the law and practice relating to the Inland Revenue Act No: 28 of 1979 and subsequent amendments thereto.

3. Wealth Tax

Co-operative societies are not liable to wealth tax. S. 42(g).

4. Rate of Tax

A Co-operative society is liable to income tax at 20%[1] on its taxable income. The taxable income of a Co-operative Society is computed by deducting any qualifying payments made in that year from its assessable income.

1. 40 of 1981.

Chapter 14

INCOME FROM TRADE OR BUSINESS

Income from trade or business carried on or exercised for however short a period is assessable to income tax. S. 3(1) (a). The definition of trade includes every trade and manufacture and every adventure and concern in the nature of trade. S. 163. The word business includes an agricultural undertaking which is an undertaking for the purpose of the production of any agricultural, horticultural or any animal produce and includes an undertaking for the purpose of rearing livestock or poultry. S. 163.

The question whether a trade is carried on is a mixed question of fact and law. The question whether a trade is being carried on or exercised must objectively pursued by first ascertaining the facts and then applying the law to find out whether the acts done constitute the carrying on of a trade. Once the answer is in the affirmative, there is liability to tax on the resulting profits. The tests for determining whether or not a trade is carried on or exercised are found in the decided cases, but these tests do not apply in every case. Thus all the relevant facts have to be considered and if total impression points to the conclusion that trade is exercised or carried on then there will be liability to income tax. Regard must be had to the character and circumstances of the particular venture.

1. The importance of distinguishing whether a trade is carried on

The difference in the rate of tax applicable to profits from an adventure in the nature of trade and capital gains will make it important to distinguish whether or not a trade has been carried on. The maximum rate at which capital gains is charged is 25% while the maximum rate of tax in respect of trade profits on an individual is 55% while on a company is 50%. Profits of an isolated transaction which are profits of a casual and non-recurring nature are not liable to income tax and may be liable to capital gains tax if the profits arise from the change of ownership of property on which capital gains are deemed to arise. Further, where a transaction has not been held to be a trading transaction and if in relation to such transaction no capital gain is deemed to arise, the entire profits will escape taxation. There is also exemption from capital gains tax where the aggregate amount of the capital gains of any person which arise in respect of movable property other than stocks, shares, debentures or debenture stock does not exceed Rs. 2,000.

There are also further advantages in making the distinction as there are benefits with regard to the treatment of losses and the deductibility of expenses connected with the transaction. A capital loss can only be set off against future capital gains while trading loss can be set off against other sources of income of that year of assessment or can be carried forward for set off in the ensuing years. In computing the profits of a trading transaction all outgoings and expenses including specified deductions (S. 23) can be deducted while in the case of capital gains computation only specified expenditure can be deducted. S. 7 (4).

2. Carried on or exercised

The expression carried on implies a repetition of acts. The expression 'trade' coupled with such words as 'carried' on or exercised' makes it beyond doubt that there should be a repetition of acts of buying and selling to constitute trade.

> "Here we have something more than the mere expressions 'trade' and 'business'. The expressions are used in association with the expression 'carried on or exercised'. The expression carried on implies a repetition of acts. When the expression 'trade' which even used by itself implies the concept of a repetition of acts of buying and selling, is coupled with such words 'carried on or exercised then it is beyond question that there should be repetition of acts of buying and selling to constitute trade".

Basnayake C. J. in the case of *CIT. v. C. S. De Soysa* 1 CTC 524. However, an isolated transaction would constitute trading where the characteristics of trading are found.

3. In the nature of trade.

The meaning of what is in the nature of trade has to be found among the judicial expressions on this subject. In the case of *I. R. C. v. Livingston* 11 TC 538, Lord President Clyde stated:

> "I think the test which must be used to determine whether a venture such as we are now considering is or is not, "in the nature of trade" is whether the operations involved in it are of the same kind, and carried on in the same way, as those which are characteristic of ordinary trading in the line of business in which the venture is made."

Where, however, the purchase and sale is made for no purpose other than of resale at a profit then the venture will be in the nature of trade even though it may be wholly insufficient to constitute trade. Thus in the case of *Rutledge v. CIR* 14 TC 490 where a money lender with interest in a cinema business bought and sold in a single lot a quantity of toilet paper at a profit, it was held to be profit from an adventure in the nature of trade. The decision was based on the reasoning that the nature and the quantity of the subject matter dealt with exclude the suggestion that it could have been dealt with otherwise than as a trade transaction.

Trade normally involves the exchange of goods or of services for reward. The trade must be with someone and must be bilateral. All transactions which have the characteristic of trading will be regarded as the carrying on of a trade but such a concept has its limitations.

> "Trade is infinitely varied; so we often find applied to it the cliche that its categories are not closed. Of course they are not; but this does mean that the concept of trade is without limits so that any activity which yields an advantage however indirect, can be brought within the net of tax."

Lord Wilberforce in the case of *Ransom v. Higgs:* 1 W.L.R. 1594. In this case the revenue contended that a person who procured others to enter into transactions, most of which were trading transactions, was carrying on a trade of procuring others to do what they did. The House of Lords refused to give such a wide and vague extension of the word trade.

4. **Characteristic of Trading Transactions**

The question whether a trade is carried on is a mixed question of fact and of law. The tests for determining whether or not a trade is being carried on or exercised are to be found in decided cases which have outlined a number of characteristics which go to show whether or not a particular transaction is in the nature of trade.

5. **Profit making motive**

Where the facts point out that there is a profit making motive, it may point to the direction that the venture is in the nature of trade, but such a conclusion is not very conclusive.

"Any accretion to capital does not become income merely because the original capital was invested in the hope and expectation that would rise in value; if it does so rise, its realisation does not make it income."

Lord Buckmaster in *Jones v. Leeming* 15 TC 355. It is not essential to the carrying on of a trade that the persons engaged in it should make or desire to make profit by it; the definition of the word 'trade' does not necessarily mean something by which a profit is made. (Lord Coleridge in *I.R.C. v. Incorporated Council of Law Reporting,* 3 TC 105).

A person may purchase an investment which produces income and may also intend to sell it at a profit when it is favourable to do so, but such transaction cannot be adventure in the nature of trade as these purchases will be on capital account.

"The individual who enters into a purchase of an article or commodity may have in view the resale of it at a profit and yet it may be that that is not the only purpose for which he purchased the article or the commodity, nor the only purpose to which he might turn it if favourable opportunity for sale does not occur. An amateur may purchase a picture with a view to its resale at a profit. and yet he may recognise at the time or afterwards that the possession of the picture will give him aesthetic enioyment if he is unable ultimately, or at his chosen time, to resell it at a profit. A man may purchase stocks and shares with a view to selling them at an early date at a profit, but if he does so, he is purchsing something which is itself an investment, a potential source, of revenue to him while he holds it. A man may purchase land with a view to realising it at a profit, but it may also yield him an income while he continues to hold it. If he continues to hold it there may be also certain pride of possession."

Lord Normand in *I.R. v. Fraser,* 24 TC 498.

Thus in the case of *I.R. v. Reinhold,* 34 TC 389, where a director of a firm of warehousemen bought four houses and sold them two years later at a profit and the profit was held to be from an isolated transaction and not from an adventure or concern in the nature of trade. It was held that although the purchase was made with a disclosed intention to sell at a profit whenever suitable opportunity arose, the subject matter of the transaction was of a kind normally purchased for investment and when the purchaser was not a person whose business was to trade in such property there was no ground to establish that the transaction was an adventure in the nature of trade.

Where a person is assessed to tax on the basis of an adventure in the nature of trade, the burden lies on the taxing authorities to establish that basis in order to do so it must be shown not merely that the assessee hoped to make a profit and bought it with that hope but rather that his actual intention or the dominant motive in making the purchase was to indulge in an adventure in the nature of trade. Thus in the case of *Mahawitharana v. C.I.R.*, 3 CTC 156 the taxpayer entered into an agreement to purchase an estate and sold part of the estate at a profit. In this case the taxpayer did not secure the option to purchase the estate himself but his dominant intention when he entered into the agreement to purchase the estate was held to be to embark on an adventure in the nature of trade.

Motive of the taxpayer is also important to determine whether or not the taxpayer has embarked on an adventure in the nature of the trade.

"If in order to get what he wants, the taxpayer has to embark on an adventure which has all characteristics of trading, his purpose of object alone cannot prevail over what he in fact does. But if his acts are equivocal, his purpose or object may be a very material factor when weighing the total effect of all the circumstances."

Lord Reid in the case of *Ram Iswara v. C.I.R.*, 3 CTC 148. The appellant in this case wished to put up a house near a convent school which her children were attending. She found a suitable building site, but the owner was however willing to sell the site 2 acres in extent as a whole, She entered into an agreement to purchase the entire land and she divided the whole of the property and sold nine lots to sub-purchasers and retained one lot for her. The Privy Council held that the transaction is an adventure in the nature of trade although the assessee retained a site as capital investment; but in order to do so she had to buy, divide and immediately sell the rest of the site which constituted an adventure in the nature of trade

The Board of Review found as facts the following in arriving at their conclusions that the transactions had the characteristics of trading.

(a) that Ram Iswara did not have the money to pay even the deposit and this sum had to be borrowed.

(b) the transaction had to be conclued within a comparatively short period of time.

(c) there was preparation, organisation and activity in dividing into lots which matured the assets.

(d) quantity and extent purchased was in excess of the alleged requirements as personal investment.

(e) there was presence of profit motive and there was considerable profits from the transaction.

6. The nature of the asset

The nature of the asset may be a pointer to the fact that there is trading. The character and the circumstances of the transaction will also indicate with definiteness that certain profits arise from adventure in the nature of trade and not capital accretion of an investment. If the venture was one consisting simply in an isolated purchase of some article against unexpected rise in price and subsequent sale, it may be impossible to say that the venture was in the nature of trade; because the only trade in the nature of which it could participate would be the trade of a dealer in such article and a single transaction falls short of constituting a dealer's trade. A person may buy capital asset which may yield income while he holds it. Any profit he derives by sale will not be profit of a trade but capital accretions. A person may buy an article or furniture, a painting or some other article for personal use and he may sell it later at a profit. The article may give him pride of possession or aesthetic satisfaction as long as he owns it.

Where an article is purchased which yields no income or any personal enjoyment to the owner and is susequently sold at a profit it may in some circumstances be considered trading. In the case of *C.I.R. v. Fraser* 24 TC 408 where an individual who was carrying on the trade of woodcutter bought and sold a quantity of whisky about which he had no special knowledge, skill and where he did not take delivery of the whisky, he was held to have embarked on an adventure in the nature of trade. The decision was on the ground that when a person deals with a trading commodity such as whisky in bulk in bond which he has acquired merely for the purpose of re-sale and proceeds to sell, and there are no other material circumstances in the case he engages in trade and in the trade only and not in investment of capital: Lord Monerill in *C.I.R. v. Frazer.*

In the case of *Rutledge v. I.R.C.* 14 TC 490 where the subject matter of the transaction was one million reels of toilet paper, it was held to be a trading transaction as the toilet reels could not have been sold otherwise than as a trading transaction.

Where the nature of the asset lends itself to commercial transaction and the search for opportunities for the sale may indicate that there is adventure in the nature of trade. A director of a leather manufacturing firm and an employee of a spinning firm jointly purchased a complete cotton spinning plant with the object of selling it at a profit as quickly as possible. They sold the machinery in five lots and the transaction was held to be adventure in the nature of trade on the ground that the subject matter of the transaction lends itself to commercial transaction *Edward v. Bairstow & Bairstow & Harrison* 36 TC 207. Then again in the case of *Martin v. Lowry* 11 TC 297, the purchase and sale of a large quantity of linen outside the ordinary occupation of the taxpayer was held to be a trading transaction as the subject matter of the purchase and sale and the methods adopted for the sale excluded the suggestion that it could have been disposed of otherwise than as a trading transaction.

7. **Alteration of the subject matter of the transaction**

If a person buys an article and carries through some process which changes the character of the article, such an act may lead to the conclusion of a trade being carried on. A blacksmith a ship owner and a fish sales employee jointly bought a ship and made extensive repairs to convert it into a steam drifter and sold it at a profit; *C.I.R. v. Livingstone;* 11 TC 538. The profit from this venture was held to be a profit from trade, not from the mere appreciation of the capital value of an isolated purchase and sale. The profit was from the expenditure on the subject purchased of money laid out upon if for the purpose of making it marketable.

Where goods are purchased in one lot and sold in smaller quantities by altering its character, may lead to the conclusion that the venture is in the nature of trade. Thus in the case of *Cape Brandy Syndicate v. C.I.R.* 12 CT 358, three persons who had no knowledge of the business of trading in brandy and had not previously engaged in such a trade bought a quantity of brandy, transported it, modified its character by blending with a view to alter it and sold the brandy in lots. The courts held that all the activities carried on by them together formed evidence upon which the courts came to the conclusion that the transaction was adventure in the nature of trade.

Any steps taken to enhance the value of the subject matter of the transaction may not always constitute trade. In the case of *Taylor v. Good;* 49 TC 277 a taxpayer living in a rented house bought a mansion for sentimental reasons with the idea to live there. He later changed his mind and obtained planning permission for development. He prepared plans for development and procured suitable road accesses in order to obtain planning permission and ultimately sold the house at a profit. The court of appeal held that the transaction did not amount to an adventure in the nature of trade. Russel L.J. in this case stated:

"If of course you find a trade in the purchase and sale of land, it may not be difficult to find that properties originally owned, for example, by inheritance, or bought for investment only, have been brought into the stock-in-trade ...... But where, as here, there is no question at all of absorption into a trade of dealing in land of lands previously acquired with no thought of dealing. In my judgement there is no ground at all for holding that activities such as these in the present case, designed only to enhance the value of the land in the market, are to be taken as pointing to, still less establishing, an adventure in the nature of trade."

8. **Repeated and systematic transactions**

Repeated and systematic transactions may lead to the conclusion that a trade is being carried on, Justice Rowlatt in the case of *Pickford v. Quirke* 13 TC 251 elaborated this point clearly;

"Now of course it is very well known that one transaction of buying and selling a thing does not make a man a trader, but if it is repeated and becomes systematic, then he becomes a trader and the profits of the transaction, not taxable so long as they remain isolated, become taxable as items in a trade as a whole ......"

In this case a director of a spinning company formed a syndicate for the purpose of purchasing shares in a mill owning company and subsequently sold the shares at a profit. He subsequently engaged himself in similar transactions and the profits of which were held to be trading profits.

In the case of *Smith Barry v. Cordy* 28 TC 250 where the taxpayer purchased a large number of endowment policies on the lives of other people with the intention of using the proceeds to live on as these mature was held to be carrying on a trading transaction and he was assesssable on the difference between the cost and the amount received on each policy.

A taxpayer's subsequent conduct coupled with repetition of previous transaction may lead to the conclusion that such person is carrying on trade. In the case of *Leach v. Pogson* 40 TC 443 where the taxpayer carried out thirty transactions in each of which he established a motoring school and sold it to a company for cash and shares. He contended that the first transaction was not a trading transaction as he had no intention of setting up other schools when he started. The courts having regard to his subsequent conduct considered that all the transactions including the first transaction was trading.

9. The length of ownership

Where a person purchases an article and holds it for some length of time before sale, this may in some circumstances lead to a finding that there is no trade. A quick sale together with other characteristics of trading may lead to conclusion that there is trading. In the case of *Turner v. Last;* 42 TC 517, where the taxpayer sold the land within four months of the purchase, the transaction was held to be a trading transaction. Cross J. observed in this case:

> "A man may buy something, whether it be land or a chattel for his own use and enjoyment with no idea of a quick sale, and then, quite unexpectedly he may receive an offer to buy which is too tempting to refuse. That is a perfectly possible state of facts; but the fact that there was a quick re-sale naturally leads one to scrutinise the evidence that it was envisaged from the first very carefully."

An intention to hold the investment may be an item of evidence to point to the fact that there was no trading. The fact that a person does not intend to hold an investment in itself is not conclusive that there is trading. Viscount Dunedin in the case of *C.I.R. v. Linigston* 11 TC 539;

> "The fact that a man does not mean to hold an investment may be an item of evidence tending to show whether he is carrying on a trade or adventure in the nature of trade in respect of his investment, but *per se* it leads to no conclusion whatever."

10. Financial resources

In determining whether the profit from disposal of an investment is capital accretion or profits from an adventure in the nature of trade, the financial resources available to the purchaser may be relevant In the case of *Ram Iswara v. C.I.R.* 2 CTC 241 it was argued that if it is a purpose of the taxpayer to acquire something for his own use and enjoyment, that is sufficient to show that the steps which he takes in order to acquire it cannot be an adventure in the nature of trade. The Privy Council rejected that argument and observed that if in order to get what he wants, the taxpayer has to embark on an adventure which has all the characteristics of trading, his purpose or object alone cannot prevail over what he in fact does. But if his acts are equivocal his purpose or object may be a very material factor when weighing the total effect of all the circumstances. It was found as evidence that the appellant had no money to pay even the deposit and that sum has been borrowed. It was an essential part of her plan that the greater part of it should immediately be sold to sub-purchasers because without the money paid by them she could not have found the money to pay for the balance due to the vendor. No doubt she acquired the part of the site which she retained as a capital investment but in order to acquire it she had to buy divide and immediately resell the rest of the site.

In the case of *California Copper Syndicate v. Harris* 5 TC 159, the company with a capital of £28,000 bought a mining property and sold the property to another company for £300,000 in exchange for shares. The courts inferred that the capital resources available to the company was insufficient to support the argument that the property was acquired as an investment.

In the case of *Turner v. Last* 42 TC 517 where a tenant farmer purchased the land he farmed when his bank overdraft was twice the purchase price was held as adventure in the nature of trade and not an accretion to capital investment. The Revenue's contention that appellant's financial position before purchase would not allow him to hold the land indefinitely as an investment lead the courts to conclude that the property was purchased with the intention to sell at a profit and the transaction is an adventure in the nature of trade.

11. Stock in trade or investment

Cases arise in which there may be evidence that an item of property is held as an investment even though the owner is engaged in a trade of dealing in such articles. Thus, in the case of *Hudson v. Wrightson;* 26 TC 55, it was observed that a property dealer may have private investment in land. Again the case of *Harvey v. Calucott* 33 TC 159, Justice. Donovan pointed out that:

"A builder can have a private investment just as much as anybody else, in the same way as a stock jobber can have a private investment in shares."

And he held that a builder in that case had discharged the onus of showing that the profit from certain sales of property was profit from an investment or something which was not a trading stock.

12. Realisation of whole or part of the assets

When property is sold in part or as a whole question will arise as to whether the profits realised are accretion to capital assets or profits of an adventure in the nature of trade. In the case of realisation of assets in respect of which depreciation allowance has been claimed any profits arising will be profits of that trade or business. S. 23(3)(a) & (b).

In the case of *California Copper Syndicate v. Harris* 5 TC 159, the company sold off its entire mining property which constituted the whole of the company's undertaking was held as an adventure in the nature of trade and not profits from realisation of capital asset of the company. The facts of the case led to the conclusion that the company did not intend to work the mine with the limited capital resources available to the company and that its purpose was to exploit the asset and obtain gain by inducing others to take it upon such terms which yielded substantial profits.

In the case of *Tebaru (Johore) Rubber Syndicate v. Farmer* 5 TC 658, the company was formed to acquire and develop rubber plantations sold the whole of its undertaking as the company did not have adequate financial resources to manage the undertaking. The memorandum empowered the company to sell the property and such sale was contemplated in the prospectus of the company. It was held that the profits on the sale was not profits of a trade.

In *C.I.R. v. Toll Property Co. Ltd.* 34 TC 13, the company sold portions of its property and while it held the property it derived income. On appeal against assessment to tax it was held that the profits were from adventure in the nature of trade considering the nature of the transaction, the purpose for which the company was formed and the objects of the company in its Memorandum of Association.

In cases of sale of assets which is isolated from the main business carried on all the circumstances attaching to the entire business must be considered in arriving at the conclusion whether the profits realised is trade profits. In the case of *Glochester Railway and Waggon Co. v. C.I.T.* 12 TC 720, the company carried on the business of manufacturing for sale and of letting waggons for hire, sold the waggons let on hire on ceasing to carry on that part of its business. The waggons that were let on hire were capitalised and appeared in the Balance Sheet. The profits arising on the sale of waggons used for hiring business was profits of that business as the object of the company was to make a profit out of the waggons.

13. **Isolated Transactions**

'An isolated transaction' means that there is no eivdence to show that the taxpayer had done anything like this before or is likely to do it again.' (Viscount Duneding in the case of *Leeming v. Jones)* 15 TC 355;

"A casual profit made on an isolated purchase and sale unless merged with similar transactions in the carrying on of a trade, or business is not liable to tax." Rowlatt J. in *Ryall v. Hoare* 5 TC 525.

Profits of an isolated transaction may be liable to capital gains tax if profits of the transaction are deemed to be capital gains. The distinction will therefore be of some importance in this context.

When a purchase and sale is on an isolated transaction, it is difficult to determine whether the transaction is in the nature of trade. The test to determine whether the venture is or is not in the nature of trade is whether the operations involved in it are of the same kind and carried on in the same way as those which are characteristic of ordinary trading in the line of business in which the venture is made: *(C.I.R. v. Livingston* 11 TC 538). Lord President Clyde said:

"...... If the venture was one consisting simply in an isolated purchase of some article against an expected rise in price and a subsequent sale it might be impossible to say that the venture was 'in the nature of trade'; because the only trade in the nature of which it could participate would be the trade of a dealer in such article, and a single transaction falls as far short of constituting a dealer's trade as the appearance of a single swallow does of making a summer."

In this an isolated purchase and sale of a ship by a blacksmith, a ship repairer and a fish sales employee was held to be trading as they embarked on activities to make it marketable.

A single set of purchase and sale of an article, goods or property could give rise to profits from trade if the single transaction amounts to an adventure in the nature of trade. Thus in the case of *Rutledge v. C.I.R.* 14 TC 491, a single purchase and sale of a large quantity of toilet paper was held to be a trading transaction.

In the case of *C.I.T. v. C. S. De Zoysa* 1 CTC 524 an isolated transaction of sale wherein the appellant sought to take advantage of the concession granted to owners of requisitioned land of purchasing the building erected thereon was held not trading profits on the ground that the transaction was an isolated one in that the assessee had to do something to dispose of the material which had already been placed on the land.

In the case of purchase and sale of property a finding that there is trading activity is necessary to bring the profits chargeable as trade profits, In the case of *Leeming v. Jones* 15 TC 334 Lawrence L.J.:

"In the case of an isolated transaction of purchase and re-sale of property there is really no middle course open. It is either an adventure in the nature of trade, or else it is simply a case of sale and re-sale of property."

However in the case of *Johnston v. Heath;* 46 TC 463, an isolated transaction by someone associated with a building company did not escape classification as a trading transaction.

In this case a firm of building engineers and contractors indicated to an employee that they would sell certain property for £15,000. The employee found three buyers and entered into a contract to sell it for £25,000. He then entered into a contract with the company to buy the land for £15,000. It was held that the profits were profits from adventure in the nature of trade in the circumstance that the taxpayer had contracted to sell before entering into the contract for the purchase, and that his offering the land to three prospective buyers made it possible to conclude that the transaction was an adventure in the nature of trade.

14. **Mutual Trading**

If the same persons are the proprietors and at the same time customers then there exist mutual trading, and any resulting profits is not assessable to income tax, for 'no man can trade with himself'. Evidence of mutuality can be found in co-operative societies and members only clubs. In order to establish mutuality it must be proved that profits derived should be capable of coming back at some time and in some form to the persons to whom the goods were sold.

A mutual life assurance company has no members other than the holders of participating policies, to whom all the assets of the company belonged. At the close of the year an actuarial valuation was made and if the aggregate receipts exceed expenses and estimated liabilities the surplus was divided between the policy holders who receive a premium in the shape of either a cash reduction from the premiums or a revisionary addition to the amount of their policies. It was held that so much of the surplus as arose from excess contributions of the participating policy holders was not profits assesssable to income tax: *New York Life Assurance Co. v. Styles* 3 TC 358.

A mutual provident association was held to be assessable on the interest income it received from its members as there existed no mutuality: *Public Service Mutual Provident Association v. C.I.T.* 1 CTC 173. By receiving income from interest which they do not contribute, though they contribute to the common fund, from which loans are made, non-borrowing members make a benefit at the expense of other contributors who borrow. The loans made by the association are taken from the common fund, and the interest is not paid out of the common fund and thus negated mutuality.

A company can make profits out of its members as customers although its range of customers are limited to its shareholders. The company is a legal person and hence its transactions with the shareholders does not involve mutuality. Section 36 provides that profits from transactions with its shareholders are assessable to income tax.

15. Illegal Trading

Profits derived from illegal activity will be chargeable with tax if it has all the characteristics of trading. Profits derived by a person from the providing of illegal automatic machines have been held to be assessable: *Mann v. Nash;* 16 TC 523. The profits from the selling of whisky in the United States in contravention of the law of that country and involving the making of untrue customs declarations in the United Kingdom was held to be liable to income tax as trading profits: *Lindsay v. I.R.* 18 TC 48. Although receipts are assessable any penalties paid for the infringement of law cannot be deducted in ascertaining the profits.

Chapter 15

INCOME FROM PROFESSION OR VOCATION

Profits or income from profession or vocation is a source of income chargeable with income tax. S. 3(1)(a). There is, however, no definition of what is profession or vocation. It is essentially a question of fact whether an individual is carrying on a profession or vocation and will be determined on the basis of evidence.

1. **What is Profession?**

Profession, according to Scrutton L. J. in *I.R.C. v. Maxse* 12 TC 41;

"Profession ......involves the idea of the occupation requiring either purely intellectual skill or of any manual skill controlled, as in painting and sculpture or surgery, by the intellectual skill of the operator, as distinguished from an occupation which is substantially the production or sale or arrangements for the production or sale of commodities. The lines of demarcation vary from time to time. The word profession used to be confined to the three learned profession the Church, Medicine and Law. It has now I think a wider meaning."

The membership of a professional organisation may be a factor leading to the conclusion that an individual is carrying on a profession, but it is not conclusive as he may engage himself in an activity outside the scope of the professional body of which he is a member – *Currie v. C.I.R.* 14 TC 245.

2. **A Company cannot carry on Profession by itself.**

It has been judicially decided that a company by itself is not capable of pursuing a profession. A profession requires personal qualities and qualifications and a company is incapable of acquiring the necessary qualities and qualifications. *Esplen Son & Swainston Ltd. v. C.I.R.* 1919 K.BB. 731; *Peter Mc Intyre Ltd. v. C.I.R.* 12 TC 1006.

In the case of *Peter Mc Intyre Ltd. v. C.I.R.* 12 TC 1006, a claim by the company carrying on a professional busines for exemption from Profits Tax was rejected on the following reasoning:–

"...... For a professional business may be carried on by a company as well as by an individual; but, if by a company, it is difficult to see how the profits can be dependent on the company's personal qualifications, for the simple reason that a company is incapable of personal qualifications. That is all, as I understand, that was decided by Mr. Justice Rowlatt in *William Esplen Son & Swainston Ltd. c. C.I.R.* 1919 KB 731 and I respectfully think this decision was right."– Lord President Clyde.

"...... The section provides that where the profits are dependent mainly on the personal qualifications of the person by whom the profession is carried on, the exemption shall hold. It appears to me that we cannot hold that this business is carried on by its employees, however well qualified they may be and however much its success may be dependent upon their qualifications and their exertion. In my view, it is the company which carries on the business and the profits which are the subject of assessment are the profits of the company. It cannot be dependent upon the qualifications of the company, the person who carries on the business, and, accordingly, I concur in the opinion which your Lordship in the Chair indicated." – Lord Sands.

"...... They may depend upon the personal qualifications of the most important person in the Company, but then the profits here are not profits for himself but profits of the Company." – Lord Blackburn.

A professional may carry on his work through a limited liability company provided the professional Code of Ethics permit incorporation. In some professions incorporation is not permitted on the ground that the professional service is intangible and an assessment of its quality relies wholly on judging the conduct and reputation of the practitioner as a warranty. Where a professional practice has been incorporated the profits will be that of the business of the company and not profits of exercising a profession.

3. Vocation

The word 'Vocation' is analogous to a 'calling', meaning the way in which a man passes his life – *Patridge v. Mallandine* 2 TC 179. An individual who habitually supplied racing forecasts to newspapers for reward was carrying on a vocation: *Graham v. Arnott* 24 TC 157; *I.R.C. v. Maxse* 12 TC 41.

4. Distinction between Profession, Vocation or Employment

It is of importance to distinguish between profession, vocation and employment as the basis of computation of profits from these sources are different. The computation of profits from profession or vocation is similar to the computation of profits of a trade or business. In the case of income from employment no deductions other than specified are allowed. S. 24(b).

The distinction to be drawn is whether a particular activity of an individual who is carrying on a profession or vocation is or is not within the ambit of the profession or vocation. The profit arising should be as a normal incident to the profession. The distinction between professions and employment is well illustrated in *Davies v. Braithwaite* 18 TC 106 by Rowlatt J.:

"It seems to be that where one finds a method of earning a livelihood which does not consist of the obtaining a post and staying in it, but consists of series of engagements and moving from one to another ...... then each of these engagements cannot be considered an employment but is a mere engagement in the course of exercising a profession and every profession and every trade does involve the making of successive engagements and successive contracts and in one sense of the word employment."

There are two factors which may go to show that an individual is carrying on a profession or vocation.

(a) the activities of the taxpayer are of the nature professional or vocational;

(b) the number of different engagements fulfilled by the taxpayer over a period is considerable.

The test to be applied to determine whether an individual is carrying on a profession or vocation and employment is to examine whether the taxpayer is employed under a contract of service or under a contract for services. The illustration of Lord Dennings in *Stevenson Jordon & Harrison Ltd. v. Macdonald and Evans* 1 TLR 101 shows clearly the distinction between the two:

"A ship's master, a chauffer and a reporter on the staff of a newspaper are employed under a contract of service: but a ship's pilot, a taximan and a newspaper contributor are employed under a contract for services."

Cook J. in *Market Investigators Ltd. v. Minister of Social Security* 2 QB 173 at page 183;

"The fundamental test to be applied is 'Is the person who engaged himself to perform these services performing them as a person in business or on his own account" If the answer to that question is 'yes' then contract is a contract of service ...... and that factors which may be of importance are such matters as whether the man performing the services provide his own equipment, whether he hires his own helpers, what degree of financial risks he takes. What degree of responsibility for investment and management he has and whether and how he has opportunity of profiting from sound management in the performance of his task."

There are a number of tests that may be applied in determining whether a person is carrying on a profession or employment:

(a) Whether the person is part and parcel of an organisation;

(b) Whether the employer or the employee supplies the instrumentalities, tools and the place of work for the person doing the work.

(c) Whether the person holds himself to the public as carrying an independent activity and has the right to provide service for more than one person.

(d) Degree of economic and personal independence.

(e) Whether a person submits himself to authority and direction.

(f) Liability to contribute to the Employees' Provident Fund under the law and liability to Turnover Tax.

(g) Whether the person carries financial and legal responsibility and has control of the material of his work.

(h) the existence of a master and servant relationship.

5. Individuals with two sources of income from profession and employment

A taxpayer may have two sources of income from profession and employment. In the case of channelled consultation practice of Specialist Doctors in the service, of the Department of Health, their salary is income from employment while their consultation fees is income from the exercise of their profession.

A taxpayer who was in private practice as a consultant also held a part time salaried appointment under the National Health Services. It was held by courts that his salary falls to be assessed under employment while the receipts from the consultancy practice was held to be from the exercise of a professional – *Mitchell and Eden v. Ross* 40 CT 56. The test applied was whether the taxpayer in respect of the particular activity in question –

(a) occupy an office; or
(b) undertake an employment; or
(c) does he merely render service in the course of the exercise of the practice of his profession (40 TC 35).

A full-time day teacher agreed to teach evening classes and she was paid under a separate agreement. It was held that the separate payment was part of the emoluments of her employment – *Page v. Mc Clelland* 36 TC 571.

A radiologist who held a full-time post at a hospital received fees from the hospital authority for lectures delivered by him to students was held to be receipt from employment – *Lindsay v. I.R.C.* 41 TC 661.

6. **Gifts made out of esteem to a Professional**

A gift made to a medical practitioner inspired by the kindness shown by the Doctor in addition to the fees paid for the professional services was held not profits from profession. In the case of *Dr. B. M. Sundaravadanam v. Income Tax Authority* (Madras Hindu August 21, 1982) a patient who was completely cured of a chronic ailment paid the doctor Rs. 4,802 as fees for the professional services rendered. The patient subsequently made a gift of land valued at Rs. 65,000 inspired by the kindness shown by the doctor. The learned judge of the Madras High Court said that it was not possible to hold, that merely because the assessee was a medical practitioner, the gift was towards the services rendered, especially when the professional services had been suitably compensated earlier. It was further held that the receipt of land by the doctor was only a casual and non-recurring receipt and consequently not subject to income tax.

7. **Computation of profits from profession or vocation**

The profits of a profession or vocation are usually made either on the earnings basis or on the cash basis. Whatever the method adopted by the taxpayer, the Revenue Authorities would insist on a consistent basis of making up the accounts.

The essential difference between the earnings and cash basis is that in the former work in progress and uncollected fees are brought into account while in the cash basis these are ignored. On the earnings basis the income of the professional business is computed by taking into account the value of service rendered during the period without any adjustments at the terminal date for amounts outstanding either in respect of work in progress or unpaid amounts in respect of completed services. On the cash basis the profits is the actual cash received during the accounting period over the expenses actually paid during the period.

Premiums received in respect of serving of articles or apprenticeship are receipts of profession. These amounts should be spread over the period of training.

8. Method of computation of profits

The rules for computation and assessing of profits of professional men for tax purposes are similar and in many respects identical to the rules employed in the ascertainment of profits from a trade. In order that an expenditure is deductible the expenditure must be incurred in the production of income. An express finding that the expenses are incurred in the course of carrying on the profession or vocation will be necessary for the expenditure to be deductible in computing the profits.

A firm of solicitors guaranteed for a client a bank overdraft to enable him complete the acquisition of a show room, to pay deposit on a house and to provide funds to carry on his business. The client was adjudged bankrupt and the solicitors claimed the sum paid under the guarantee to the bank on the ground that it was their usual practice and part of their business to guarantee loans. The court held that the sum was not deductible on the ground that the expenditure does not come within the course of their profession – *Jennings v. Barfield and Barfield* 40 TC 365.

9. Depreciation on Books

In the case of *Munby v. Furlong* (April 1976) it was held that text books were physical chattels and were plainly used by a barrister to carry on his profession. He used the information in them for his profession as a barrister and the books are apparatus used by him in his profession. The expenditure on the initial purchase of such books thus constituted an expenditure on plant for tax purposes.

In the past only expenditure in maintaining libraries were allowed as deduction, while the expenditure on the establishment of libraries were not allowed. This position has been altered by this recent decision. The initial expenditure in the establishment of a library is capital expenditure and the taxpayer will be entitled to claim appropriate depreciation allowance.

10. Subscriptions to Professional Associations and expenditure on travel abroad to participate in any seminar or conference relating to the profession. S. 31(1)(j).

A professionally qualified individual can deduct from the assessable income payments in respect:–

(a) the subscription to any professional association of which he is a member;

(b) in the purchase of professional books, journals and reports;

(c) on travel abroad for the purpose of participation in any seminar or conference relating to the profession carried on or exercised by that individual if such purpose is approved by the Minister as being of benefit or general advantage to such profession.

Deduction from the assessable income in respect of the foregoing and other qualifying payments during an year of assessment shall not exceed one third of the assessable income of that person. S. 31(5).

11. **Cost of travelling between residence and place of business**

Travelling expenditure between residence and place of business cannot be deducted in arriving at the profit of a profession or vocation. S. 24(1)(a). However, the expenses incurred by an advocate in travelling from the premises in which he resides and has his chambers to the Supreme Court are not cost of travelling between residence and place of business. The chambers of an advocate and courts are the place of business of an advocate and therefore the movements from one place of business to another does not come within the scope of the prohibition: *Rajapakse v. C.I.T.* 1 CTC 27.

12. **Exemption of profits and income earned in foreign currency outside Sri Lanka in the course of profession or vocation while being resident of Sri Lanka for tax purposes.** S. 15(c).

Emoluments earned in any year of assessment by any individual resident in Sri Lanka in respect of services rendered by him in that year of assessment outside Sri Lanka in the course of any profession or vocation is exempt from income tax provided such emoluments less amounts expended by him outside Sri Lanka as is considered by the Commissioner General to be reasonable personal expenditure, is remitted by him to Sri Lanka. S. 15(c).

The exemption of profits earned in foreign currency is now extended to any resident partnership which carries on or exercises any profession or vocation provided such profits and income less reasonable expenses are remitted to Sri Lanka. S. 15(cc). The exemption covers business profits and professional services rendered by a company and will also qualify for exemption. S. 15 (cc).[1]

1. 27 of 1982.

Chapter 16

PROFITS FROM ANY EMPLOYMENT

Profits from employment is a source of income chargeable with income tax: S. 3(b). The basis of assessment of income from any employment is on the current year basis: for example, the profits from any employment for the period 1st April 1982 to 31st March 1983 is chargeable for the year of assessment. 1982/83. The Pay As You Earn system of tax recovery operates in respect of income from employment (Chapter 27).

The word 'employment' has a wide meaning, in that it includes all receipts received in reference to and in the nature of reward for services rendered. It is sometimes difficult to ascertain whether an individual is carrying on an employment or profession or vocation. A test which is often applied to determine whether an individual is carrying on a profession or employment is to examine whether the taxpayer is employed under a contract of service or under a contract for service. This distinction is illustrated by Lord Dennings in the case of *Stevenson Jordon & Harrison Ltd. v. Macdonald and Evans* 1 TLR 101:

> "A ship's master, chauffer and a reporter on the staff of a newspaper are employed under a contract of service: but a ship's pilot, a taximan and a newspaper contributor are employed under a contract for services."

Another test to be applied is to determine whether the relationship of master and servant exist such as degree of control exercised by the master.

1. **Profits from any employment:** S. 4.

Profits from any employment include the following cash and non-cash benefits as income from employment.

(a) **Any Payments received or derived from the employer or others:**

These include the following:

(i) Any wages, salary, allowance, leave pay, fee' pension, commission, bonus, gratuity, perquisite, or such other payment in money which an employee receives in the course of employment. S. 4(a)(i).

(ii) the value of any benefits, including the value of any holiday warrant or passage to the employee, or his spouse, child or parent: S. 4(ii).

(iii) Any payment to any other person for the benefit of the employee or of his spouse, child or parent; S. 4(a)(iii).

(b) the value of any conveyance granted free of any charge or any sum granted for the purchase of any conveyance by the employer to any employee: S. 4(b).

(c) Any retiring gratuity or any sum received in commutation of pension: S. 4(c)(i).

(d) Any sum paid from a provident fund approved by the Commissioner General to any employee at the time of his retirement excluding such part of the employee's contribution to the provident fund made after April 1, 1954: S. 4(c)(ii).

(e) Any sum received by an employee from a regulated provident fund excluding –

(i) sum representing his contributions:

(ii) sums representing the contributions made by the employer to the fund prior to April 1, 1968 and the interest accrued on such contributions if tax at the rate of 15 % has been paid by the employer on such contributions and interest: S. 4(c)(iii).

(f) Any sum received as compensation for loss of any office or employment: S. 4(c)(iv).

(g) The rental value of any place of residence provided rent free by an employer. Where the place of residence is provided at a rent less than rental value, the excess of the rental value will be regarded as employment income: S. 4(d).

2. **Profits from employment which are exempt from income tax:** S. 9(1).

Following emoluments are exempt from income tax:

(a) the emoluments, pension and any other benefits from the office of the President of the Republic of Sri Lanka: S. 9(1)(a).

(b) the official emoluments and pension or retiring gratuity or sums received in commutation of pension or sum paid from an approved provident fund on retirement to the following are exempt from income tax:

(i) any person who holds any paid office under the Republic;

(ii) a judicial officer;

(iii) an employee of a local authority;

(iv) an employee of a Public Corporation;

(v) an employee of a University established or deemed to be established by the University Act No. 16 of 1978;

(vi) An employee of any business undertaking acquired by or vested in the Government; S. 9(1)(b).

This exemption will not apply to any individual who is not a citizen of Sri Lanka and who;

(a) has entered into a contract of employment; or

(b) is brought to, and employed in Sri Lanka;

on or after November 15, 1979 with or by any undertaking. S. 9(2).[1]

(c) the official emoluments of any member or employee of any board

1. 24 of 1980.

or commission of inquiry established by or under any law where all the members are appointed by the President or by a Minister S. 9(1)(b)(vii).

This exemption will not apply to any individual who is not a citizen of Sri Lanka and who;

(i) has entered into a contract of employment; or

(ii) is brought to, and employed in Sri Lanka,

or after November 15, 1979 with or by any undertaking. S. 9(2).[1]

(d) the emoluments arising in Sri Lanka and income not arising in Sri Lanka of any individual who is a scientist, technician, expert or adviser who is not a citizen of Sri Lanka and:–

(i) who is employed in Sri Lanka under a contract of employment with the Government of Sri Lanka or a Public Corporation or an institution approved by the Minister. S. 9(1)(c)(i).

(ii) engaged in performing any services in any project carried on by:–

(a) Government of Sri Lanka; or

(b) such public Corporation; or

(c) any other body Corporate of which the Government or a public Corporation has made a contribution: S. 9(1)(c)(ii).

(iii) who is brought to and employed in Sri Lanka –

(a) by the proprietor of an undertaking related to tourist hotels; or

(b) by any undertaking with which an agreement has been entered into by the Greater Colombo Economic Commission: S. 9(1)(c)(iii).

The exemption will cease to apply after the date of cessation of employment by such individual in that undertaking or the date on which the exemption of profits from that undertaking ends, whichever date is the earlier.

(iv) who is brought to and employed in Sri Lanka by the proprietor of any undertaking approved by the Minister, exemption being applicable for such period as is specified in this approval. However, exemption will not apply after the date of cessation of employment of such individual in such undertaking or the date on which such undertaking ceases to be an approved undertaking, whichever date is earlier.

This exemption will not apply to any individual who is not a citizen of Sri Lanka and also

(a) has entered into a contract of employment; or

(b) is brought to and employed in Sri Lanka,

on or after November 15, 1979 with or by any undertaking except in the case of individuals brought to and employed by any undertaking with which an agreement has been entered into by the Greater Colombo Economic Commission[1]

---

1 24 of 1980

(e) the employment arising in Sri Lanka and any income not arising from Sri Lanka of an individual who is not a citizen of Sri Lanka who is brought to and employed by a proprietor of an undertaking:

(i) operating hotel for tourists: and

(ii) providing building for the operation of hotel for tourists:

is exempt from income tax for a period of three years from the date of employment. The capacity in which such individual is employed must be approved by the Minister on the recommendation of the Ceylon Tourist Board: S. 9(1)(d).

This exemption will not apply to any individual who is not a citizen of Sri Lanka and who

(a) has entered into a contract of employment; or

(b) is brought to and employed in Sri Lanka;

on or after November 15, 1979 with or by any undertaking. S. 9(2).[1]

(f) the emoluments arising in Sri Lanka and of any income not arising in Sri Lanka of an individual who is not a citizen of Sri Lanka and has entered into a contract of employment or is brought to and employed in Sri Lanka on or before November 15, 1979 by a non-resident contractor in the performance of a contract the profits of which are exempt from income tax. S. 9(1)(e).[1]

(g) the official emoluments arising in Sri Lanka and income not arising in Sri Lanka of the following are exempt from income tax: S. 9(1).

(i) The Diplomatic Representative in Sri Lanka of the Government of any other country: S. 9(1)(f)(i).

(ii) any member of the staff of any Diplomatic Representative, any Consul or Trade Commissioner, provided that the Minister is satisfied that similar exemption from income tax apply in that country to a corresponding official of Sri Lanka Government.

This exemption will not apply if such person carries on or exercises in Sri Lanka any other employment, or any trade, business, profession or vocation.

This exemption will apply only to the citizen or subject of the country represented by the Diplomatic representative: S. 9(1)(f)(ii).

(iii) The emolument of any expert, adviser, technician or official whose salary or emolument is not payable by the Government of Sri Lanka and who is brought to Sri Lanka through:

(a) any specialised Agency of the United Nations Organisation; or

(b) Point Four Programme of the Government of the United States of America; or

(c) the Colombo Plan organisation including its Technical Assistance Bureau; or

(d) Asia Foundation;[1] or

(e) Any other Organisation approved by the Minister as being of similar character. S. 9(1)(f)(iii).

---

1 24 of 1980

(iv) Emoluments of any trainee from abroad who is sent to Sri Lanka under any technical assistance programme of the United Nations and its specialised Agencies or other Organisation approved by the Minister: S. (9)(1)(f)(iv).

(v) Emoluments of any official of the United Nations who is a resident in Sri Lanka and who is not a citizen of Sri Lanka; S. 9(1)(f)(v)

(vi) Emoluments of any member of the Naval, Military and Air Forces of any country who are in Sri Lanka at the request or concurrence of the Government of Sri Lanka; S. 9(1)(f)(vi).

(vii) The emoluments of persons employed in a civil capacity by the Government of any other country who are employed in or visits Sri Lanka for any purpose connected with the presence of any Naval Military or Air Forces. Such person should not have been resident in Sri Lanka for a period exceeding three months prior to date of commencement of employment: S. 9(1)(f)(vii).

(viii) Emoluments of any person who is not a citizen of Sri Lanka and who is employed in Sri Lanka by the Asia Foundation. S. 9(1)(f)(viii).[1]

The liability to income tax of persons referred to in paragraph (i), (ii), (iii), (iv) or (v) on other income arising in or derived from Sri Lanka will be determined on the basis that such persons are non-resident of Sri Lanka.

(h) the emoluments of any citizen of Sri Lanka who is employed as an expert, adviser, technician or official of the United Nations Organisation or any specialised Agency of that Organisation: S. 9(1)(g).

(i) the emolument of any individual who is employed by the World Tourism Organisation; S. 9(1)(h).

(j) the value of any travel warrant or passage granted to a person who is not a citizen of Sri Lanka to come to Sri Lanka to assume duties, to visit his home abroad[1] or to return from Sri Lanka on the termination of his services. The exemption will apply in respect of these to his wife, or any son or daughter of the person employed. The exemption is limited to one son and one daughter: S. 9(1)(e).

(k) any allowance granted by an employer for travelling, subsistence and lodging in respect of travel by such employee outside Sri Lanka in connection with his employment: S. 9(1)(j).

(l) emoluments earned in foreign currency by an individual resident in Sri Lanka in respect of services rendered by him in that year of assessment outside Sri Lanka in the course of employment carried on or exercised by him, if such amount, less reasonable personal expenses, are remitted to Sri Lanka. S. 9(1)(k).

(m) emoluments earned in any year by an individual employed in a ship which is;

(i) owned or chartered bv a company registered in Sri Lanka as an

---

1. 24 of 1980.

off-shore Company under part VIII of the Companies Act No. 19 of 1982; and

(ii) deemed to be a Ceylon ship by reason of a determination made under paragraph (c) of section 30 of the Merchant Shipping Act No. 52 of 1971. A ship shall be deemed to be a Ceylon ship when it is owned wholly by any body corporate as may be determined by the Minister. S. 9(1)(kk).[1]

(n) the value of any free transport by motor coach provided by an employer to an employee for travel by such employee, from his residence to his place of work or from his place of work to his residence. S. 9(1)(m).[2]

3. Profits received in the course of employment

Profits from any employment is defined to cover wages, salary, allowance, leave pay, fee, pension, commission, bonus, gratuity, perquisite or such other payment in money which an employee receives in the course of his employment. S. 4(a)(i). "It will be observed that the kinds of receipts enumerated, beginning with the item "wages" and going down to "perquisite' are receipts in respect of a person's service as employee or in the capacity of an employee ...... The words such other payments in money, even if the wording is inadequate to bring in the *eiusdem generis* rule, the context, however, seem to indicate that the receipt must be one derived by reason of his employment. The statute requires that these receipts must be payments "which an employee receives in the course of his employment": Wimalasundara J. in *Kanagasabapathy v. C.G.I.R.* SC 16/79.

In the course of his employment

The meaning of the phrase 'in the course of employment' was considered in the case of *Kanagasabapathy v. C.G.I.R.* by Wimalasundera J. He said that the relevant provision of our law has been interpreted on the same lines as the U. K. legislation by the Courts in U. K. and such interpretation is followed by Courts in Sri Lanka.

"The material portion of the corresponding U.K. provision stated that tax is chargeable "on every person having or exercising an office or employment of profit ...... in respect of all salaries, fees, wages, perquisites or profits whatsoever therefrom." It will be observed that these words are capable of the wider meaning, but the U.K. courts have rightly limited "profits whatsoever therefrom" to profits received in the capacity of an employee. In my view the position here is no different."

In *Dewhurst v. Hunter,* 1932 A.E.R. 753 at 761, Lord Atkin, construing these provisions of the U.K. law, said –

"Rule I (of the Rules applicable to Schedule E) appears to me to indicate emoluments either received from the employer or from some third party ...... as a reward for services rendered in the course of employment".

It will be observed that this language appears like an exact paraphrase of section 3(4)(a)(i) of our tax law. (Inland Revenue Act No. 4 of 1963).

Lord Radcliffe in *Hochstrasser v. Mayes* (1959) 3 A.E.R. 817 at 823, made the following observations in interpreting the above provisions and

1. 27 of 1982 2. 24 of 1980.

those observations, in my opinion are equally relevant in the context of our provisions and brings out its true meaning:–

"...... the statutory requirement that the payment, if it is to be th subject of assessment, must arise 'from' in this context. It has been said that the payment must have been made to the employee 'as such'. It has been said that it must have been made to him 'in his capacity of employee'. It has been said that it is assessable if paid 'by way of remuneration for his services' and said further that this is what is meant by payment to him "as such". These are all glosses and they are all of value as illustrating the idea which is expressed by the words of the statute. But it is, perhaps, worth observing that they do not displace these words. For my part, I think that their meaning is adequately conveyed by saying that, while it is not sufficient to render a payment assessable that an employee would not have received it unless he had been an employee, it is assessable if it has been paid to him in return for acting as or being an employee."

In the same case Viscount Simonds quoted with approval the following statement of the law from the judgment of Upjohn J. before whom that case had come up in the first instance:–

"In my judgment, the authorities show this, that it is a question to be answered in the light of the particular facts of every case whether or not a particular payment is or is not a profit arising from the employment. Disregarding entirely contracts for full consideration in money or money's worth and personal presents, in my judgment not every payment made to an employee is necessarily made to him as a profit arising from his employment. Indeed, in my judgment, the authorities show that, to be a profit arising from the employment, the payment must be made in reference to the service the employee renders by virtue of his office, and it must be something in the nature of a reward for services past, present or future."

In approving this quotation Viscount Simonds said –

"In this passage, the single word 'past' may be open to question, but apart from that it appears to me to be entirely accurate."

In the same case Lord Cohen, who also made an effort to get at the correct meaning of the U.K. provision, quoted with approval the following statement from the judgment of Morris, L.J., in *Bridges v. Howitt, Bridges v. Bearsley,* (1957) 2 A.E.R. 295 at 296 –

"The words 'therefrom" must be construed in the context. A profit accruing by reason of holding an office or employment may be a profit 'therefrom'. This may be so even though some payment which is received, is not made by the employer of the receipient and even though the payment is made voluntarily. The profit need not necessarily be made in the form of a cash payment. The conception which is introduced by the word 'therefrom' is that some taxable remuneration may accrue to a person by reason of having or exercising an office or employment of profit. The reference is to what is received by the holder of an office or employment in that capacity; to the holder of the office or employment as such".

Lord Cohen went on to say –

"My Lords, I am prepared to accept that statement of the law but it is, I think, clear from the final conclusion of Morris, L.J., in his judgment in the present case (see, especially *Beak v. Robson,* (1943) 1 All E.R. at p. 47; 25 Tax Case at p. 41) per Viscount Simonds, L.J., and *Cowan v. Seymour* (7 Tax Case at p. 384), per Younger, L.J.), that it is not enough for the Crown to establish that the employee would not have received the sum on which tax is claimed had he not been an employee. The court must be satisfied that the service agreement was the *causa causans* and not merely the *causa sine qua non* of the receipt of the profit."

'I do not think that our law is in any way different in this regard from the position obtaining in the U.K.' ......"

The statement of the law as approved by the Supreme Court thus provide us the principles which have to be applied in deciding whether a payment received by an employee is or not an emolument received 'in the course of his employment. The decided cases throw some guidelines. To render a payment liable to income tax as received in the course of employment such payment must be made in reference to and in the nature of a reward for services. Thus in the case of *Pritchard v. Arundale,* 47 TC 680, the controlling shareholder of a company persuaded the taxpayer to give up his practice as a Chartered Accountant and enter into a service contract for seven years with the company as its managing director and was allotted shares in the company to compensate him for the loss of professional status. The courts held that the value of shares allotted to him is not an emolument from his office.

Megarry J. said –

"The payment must be an emolument 'from' the office or employment; and I do not think 'from" means 'for'. In other words, the payment must be made in reference to the service rendered under the office or employment and as a reward for them, and so in that sense flow 'from' the office or employment; and this is not the same as a payment made 'for' undertaking the office or employment."

In *Hochstrasser v. Mayes;* 38 TC 673, a company operated a housing scheme for its employees and in order to facilitate transfer of its employees to other places of work the company agreed to indemnify the employee against any loss incurred on sale of such house occasioned by any transfer to another place of work. The House of Lords held that a payment made by the company to the employee to make good the loss was not taxable. The reasoning of Lord Radcliff for his decision is:

"The essential point is that what was paid to him was paid to him in respect of his personal situation as a house-owner who had taken advantage of the housing scheme and had obtained a claim to indemnity accordingly. In my opinion, such a payment is no more taxable as a profit from his employment than would be a payment out of a provident or distress fund set up by an employer for the benefit of employees whose personal circumstances might justify assistance".

A payment made to an employee, a bank clerk, whose terms of employment stipulated that he shall study and sit for the examinations of the Institute of Bankers so that they will be better qualified as bank clerks and later as bankers was held not profit from employment; *Ball v. Johnson,* 47 TC 155. It was held that the reason for the payment was the respondent's success in passing the examination and that the payment received had nothing to do with his past service. In *Clayton v. Gothorp,* 47 TC 168, a local authority employee received a loan to enable her to follow a course of study on an agreement that the obligation to repay the loan would cease on serving the local authority for eighteen months after the completion of the course. The loan became irrecoverable on completion of the eighteen months service and the courts held that since the subsequent period of service had made the loan into an absolute payment, this sum was a reward for service and as such taxable as an emolument.

A free benefit conceded out of benevolence to employees who are in difficulties will not be regarded as employment income. In the case of *Kanagasabapathy v. C.G.I.R.,* S.C. 16/79 reimbursement of medical expenses of his mother under the Health Insurance Scheme provided by the Central Bank of Ceylon was held to be not profits from employment.

"The essential point is that what was paid to the appellant was paid to him in respect of his personal situation, for he had taken advantage of the Health Insurance Scheme and was accordingly entitled to an indemnity. This payment which was a reimbursement of expenses for his mother's illness had, if at all, only a remote connection with his service. The payment from a distress fund or a fund of a similar nature would *prima facie* indicate that such funds are set up by the employer for the benefit of employees whose personal circumstance justify assistance, such a payment cannot, in any view, be regarded as a profit from employment."
– Justice Wimalasundera.

The mere fact that payment is made to the employee as a result of or in connection with his employment is not enough to render the payment liable to tax. Thus a special bonus paid to the employee in view of his exceptional services to the company and in consideration of the fact that he had to undergo medical treatment at home and abroad was held to be not profits from employment: *Craib v. C.I.T.;* 1 CTC 138. It was held that the long service rendered by the applicant to the company was the motive, but not the consideration for the payment. A sum paid to a director and manager under his service agreement was not regarded as profits from employment where he covenanted in consideration of the payment that he will not compete with the company within a radius of 50 miles for five years after his ceasing employment: *Beak v. Hobson:* 25 TC 33.

A company paid to the widow of a deceased employee a sum of money being accumulated leave pay, which the company placed to the reserve as a contingent liability. The payment of this sum to the widow was held to be a gift to the widow and not income from employment of the deceased husband: *Sutherland v. C.I.T.;* 1 CTC 403. The decision was on the basis that the motive for the gift was the circumstances that it represented a sum of money that the husband would have been entitled to if he survived though he died before he became entitled to it. The court also took into account that there was no evidence of an express or implied contractual obligation of the company to pay the leave pay to the deceased.

An employee who received shares at preferential terms was held to be liable on the difference between the offer price and the value of the shares on the first day of issue in the case of *Tvrer v. Smart (H.L.)* (New Law Review

21st December, 1978 page 1245). In this case a company going public offered 10 percent of the shares on preferential terms of £1 per share to to all United Kingdom employees with at least five years service. An employee applied for and was allowed 5,000 shares on this basis. On the first dealing day the shares reached 27s. 6d. The Commissioners found as fact that the purpose of the offer of shares to employees at a preferential price was that the officer would become and continue to be loyal employees, having an understanding of, and a sense of involvement in, the affairs and fortunes of the company. Lord Diplock said that this seemed to him a clear finding that the offer was made as a reward for past (since he had to have served five years to qualify) and more particularly for future services and accordingly was made to him in return for acting as or being an employee. The value of the emolument was held to be the difference between the offer price and the value of the shares on the first day of issue.

4. **Prequisites**

Perquisites denote something acquired which the acquirer becomes possessed of and can dispose of to his advantage, in other words, money or that which can be turned to pecuniary account. Thus if substantial things of money value were capable of being turned into money, they might for that purpose represent money's worth and therefore be taxable. Thus in the case of *Tennant v. Smith* 3 TC 158 rent free accommodation granted to a manager of a Bank was held not taxable as emolument on the reasoning that the benefit was not capable of being turned into money. Thus, perquisite to be taxable must be something which is capable of being turned into money.

"I think it has been generally assumed that this decision *(Tennant v. Smith)* does impose a limitation upon the taxability of benefits in kind which are of a personal nature, in that it is not enough to say that they have a value to which there can be assigned a monetary equivalent. If they are by their nature incapable of being turned into money by the recipient they are not taxable, even though they are in any ordinary sense of the word of value to him." – Lord Radcliff in *Abott v. Philbin* 39 TC 82.

A taxpayer entered into a voluntary car loan agreement under which he agreed for an "amended wage" whereby his original wage is reduced by the amount of the loan. The loan agreement provided for the cancellation of the loan on fourteen days notice by either parties and on cancellation of the car loan his wages would be restored to its original level. The House of Lords held that the loan is a perquisite as the loan could be converted into money by exercising the option of cancelling the agreement resulting in the restoration of his wages to its original level: *Heaton v. Bell* 46 TC 211.

A benefit in kind cannot escape taxation by providing a contract collateral to the contract of employment.

"...... it must not be supposed that I assent to the proposition that a benefit in kind can escape all charges to tax as a perquisite by limitations on the employees right to deal with it imposed by a contract collatteral to his contract of employment into which he enters by his own volition." – Lord Diplock: *Heaton v. Bell* 46 TC 238.

The liability to tax on perquisite is limited to payments received in money or benefits that can be converted into money, unless there is statutory provision to tax the value of any benefits. It must be noted, that value of certain benefits, for example, rental value of residence, value of holiday warrant or passage which cannot be converted into money are taxable under specific provisions providing for their liability to taxation as emoluments.

5. **Benefits**

The value of any benefits to the employee or his spouse, child or parent whether received or derived from the employer or others is profits from employment. S. 4(9)(ii). The benefit assessable to tax is the amount that can be obtained by converting that benefit into money. In *Wilkins v. Rogerson* 39 TC 344, the taxpayer had the right to 'receive a suit from a particular tailor, and cannot receive the money value or assign the right to receive the suit for money. The Courts held that the amount assessable as benefits from employment is not the cost of the suit to the employer but the second hand value of the suit. In the case of *Laidler v. Perry* 42 TC 351 the employer made available to each qualifying employee gift vouchers for use in the shop of the employees choice at Christmas time. The benefit assessable as profits from employment is the face value of the vouchers. In *Nicoll v, Anstin* 19 TC 531 where the employer paid for the telephone rates and gardeners wages. The amount regarded as profits from employment was the money value which the taxpayer got from the discharge of these liabilities by the employer. Where money liabilities are discharged by the employer, the benefit to the employee is the money's worth of the immunity that they were thus given from their own liabilities. The value assessable is the actual liabilities settled and no valuation will be necessary.

The benefits will not be liable if they are given on personal grounds and not as payment for services by an employee. In the case of *Laidler v. Perry:* 42 TC 351 where gift vouchers were given to all qualifying employees was held profits from employment as the vouchers were given in return for services rather than gifts not constituting reward for services.

> "In the result the vouchers were distributed by the employers in their capacity as employers and because they were employers they were received by the employees in their capacity as employees because they were employees. In these circumstances the emoluments were from employment." – Lord Morris in *Laidler v. Perry*.

6. **Received or derived from employer or others**

The definition of profits from employment is wide enough to cover benefits, perquisites or payment received or derived from persons other than the employer. Liability will arise where such payments or benefits accrue to the employee by reason of their employment for services rendered. In *Calvert v. Wainwright* 27 TC 475, the learned Judge held that the tips received by a taxi driver from customers was liable as the tips were received as a reward for services rendered and that voluntary gifts made by persons other than the employers are assessable to tax as part of profits arising out of employment given in the ordinary way as a reward for services. A wholly voluntary Easter offering to a vicar by the congregation where the amount given was entirely regulated by the discretion of the subscriber was held to be profits from employment as the offering were given to Vicar as Vicar and as such formed part of the profits accruing by reason of his office.

The proceeds of a benefit match which was donated by individual spectators who were not the employers of the taxpayer was held liable as the collections represented part of his earnings which accrued to him by reason of the contract of employment: *Moorhouse v. Dooland:* 36 TC 1.

7. Gifts and voluntary payments

Gifts and voluntary payments made to the employees by the employer or by persons other than employers would be profits from employment if it is given in the ordinary way as reward for services even although the payments may be voluntary. The test to be applied to determine whether such payments come within the scope of employment income can be found in the judgment of Viscount Cave in the case of *Seymour v. Reed:* 11 TC 625:

> "I think, it must be taken as settled that they include all payments made to the holder of an office or employment as such that is to say, by way of remuneration for his services even though such payments may be voluntary – but they do not include a mere gift or present (such as testimonial) which is made to him on personal grounds and not by way of payments for his services."

In this case the award of the proceeds of the benefits match to the cricketer was held not a profit accuring to him in respect of his office or employment but was in the nature of a personal gift and escaped taxation.

Gifts made by the employer to all qualifying employees was held to be profits from employment in the case of *Laidler v. Perry* 42 TC 351. In this case gift vouchers were made available to all qualifying employees at Christmas time and these vouchers were available for use in the shop of the employees choice. The court took the view that these vouchers were money's worth and would form part of profits from employment; and have been given in return for services rather than as gifts not constituting a reward for services. In this case Lord Reid observed that a payment by an employer out of benevolence to an employee would not come within liability. Lord Dennings further observed that where the gift was a box of cholocates or a bottle of whisky or a sum of money would merely be a gesture of goodwill without regard to services at all. Where the gifts are made to all employees such gifts can be considered as profits from employment.

In the case of *C.I.R. v. Morris:* 44 TC 685, payments made to some half the employees seconded to the service of an Electricity Board by the Atomic Energy Authority as an appreciation of their work was held not profits from employment.

A mere connection between the gift and the employment does not make a gift profits from employment. A gift to be taxable must arise from the office or employment.

> "...... gifts and voluntary payments are not as such assessable to income tax but if they are made with definite reference to the employment, they are assessable. Such a payment is more readily to be held to be assessable if it is made by the employer, 'than if made by someone not in the direct position of his employer ...... a payment which has no direct connection

with the taxpayer's remuneration or employment is not an emolument. A mere link between gift and the employment is not enough to say that without the employment the gift would never have been made." – Lord Megadale in *C.I.R. v. Morris;* 44 TC 685.

A mere gift or present (such as testimonial) which is made to an employee on personal grounds and not by way of payment for services rendered by the employee is not liable as profits.

In the case of *Moorhouse v. Dooland,* 35 TC 1, a cricketer was entitled to, on the days when his play is particularly successful, to have a collection taken for him on the ground was held to be profits from employment, Jenkin L.J. in his judgment summarised the principles to determine whether a payment is a gift or remuneration in respect of an employment.

"The test of liability to tax on a voluntary payment made to the holder of an office or employment is whether from the standpoint of the person who received it, it accrues to him by virtue of his office or employment, or other words, by way of remuneration for his services. If the recipient's contract of employment entitled him to receive the voluntary payment that is strong ground for holding that from the standpoint of the recipient it does accrue to him by virtue of his employment, or in other words by way of remuneration for his services. The fact that the payment is of a periodic or recurrent character affords a, further, but ...... less cogent, ground for the same conclusion. On the other hand, a voluntary payment may be made in circumstances which show that it is given by way of present or testimonial on grounds personal to the recipient. In such cases the proper conclusion is likely to be that the voluntary payment is not a profit accruing to the recipient by virtue of his office or employment but a gift to him as an individual paid and received by reason of his personal needs ...... or by reason of his personal qualities or attainments."

8. **Receipts which are not arising from employment.**

In order to determine whether certain receipts by an employee is profits from employment it must be established that the payment is in reference to the service the employee has rendered by virtue of his office and must be something in the nature of reward for service, past present or future. An amateur rugby football player was paid a sum of money for relinquishing his amateur status and become a professional player for a club. This payment was held to be a capital sum received by the player as compensation for relinquishing his amateur status and was therefore not profits from his employment: *Jarrold v. Boustead* 41 TC 701. Then a payment made to a Chartered Accountant as an inducement for giving up his practice in order that he can join the company as an employee was held not profits from employment on the ground that the payment was not in reference to the services rendered or as a reward for the service but for undertaking the employment. *Pritchard v. Arunadle:* 47 TC 680.

Any payments which are outside the normal relationship of the employee and the employer may not be profits from employment. A Chairman of a company was entitled to compensation for loss of office in terms of the articles of association of the company, On his agreeing to waive his right for compensation, he was paid £10,000 and the company agreed to keep him as an ordinary director at a salary. The payment was held to be not profits from employment. *Hunter v. Dewhurst* 16 TC 605. The basis for the decision was stated by Lord Atkin in that case.

"It seems to me that a sum of money paid to obtain a release from a contingent liability under a contract of employment cannot be said to be received 'under' the contract of employment, is not remuneration for services rendered or to be rendered under the contract of employment, and is not received 'from' the contract of employment."

However, in the case of *Cameron v. Predergast:* 25 TC 122, a director of a company was persuaded not to resign from the directorship on payment of £45,000 whereupon he agreed to continue in the company's service on a reduced salary devoting less time. It was held that the receipt was an emolument of his office as a Director.

9. Fees.

Fees received in one sum is profits from employment and not a receipt of a casual or non-recurring nature on the basis that the taxpayer is not likely to receive such fees in future. Thus in the case of *Wickremasinghe v. C.I.T.:* 1 CTC 329, the assessee received Rs. 15,000 as fee for acting as an arbitrator was held to be profits from employment and not a profit of a casual or non-recurring nature, on the ground that the word 'employment' is not restricted to the case of a man engaged by another. Howard C.J. in this case referred to the judgment of Denman J., in *Patridge v. Mallanadaine;* 2 TC 180 as authority for his decision.

"The words are 'profession, employment or vocation'. I do not feel myself disposed to put so limited a construction upon the word 'employment' as Mr. Graham desires us to put upon it. I do not think 'employment' necessarily means a case in which a person is set to work by other means to earn money. A man may employ himself in order to earn money in such a way as to come within that definition."

10. Value of free passage.

The value of free passage, in order to be regarded as income from employment must be given to the employee in reference to the services the employee rendered by virtue of his office. Where the holiday passage is paid to an employee as a favour the payment is not profits from employment. *C.I.R. v. J. de Fonseka* 3 CTC 255. In this case the employees of Air Ceylon are eligible to ask for such favour which is determined by reference to their employment, but the selection of the recipient is made depending on the arbitary choice of an official of the Air Ceylon.

11. Free meals or clothing

Where the clothing is required to be worn by the employee while working such as uniforms or protective clothing, the value will not be regarded as profits from employment. The value of a policeman's uniform was held not taxable in the case of *Fergusson v. Noble* 7 TC 176. Where the clothing can be worn outside the office or workplace or is exchanged for money is taxable as receipts of moneys worth *Wilkins v. Rogerson;* 39 TC 344. Free meals which are consumed are not moneys worth and are therefore not taxable provided such meals are not exchanged for money. Providing of vouchers or other means for purchase of meals are taxable.

12. Payments of Employees income tax.

Where the employer discharges the income tax liability of the employee the amount so discharged is profits from employment. *Hartland v. Diggins:* 10 TC 247. Where the employee receives salary free of tax the employee's income will be the gross salary i.e. the gross salary he would have received if he were to pay the income tax on his salary.

13. Payment received under Health Insurance Scheme

In the case of *Kanagasabapathy v. C.G.I.R.* S/C 16/79. Supreme Court held that amounts received by an employee as reimbursement of medical expenses incurred by his mother under the Health Insurance Scheme is not profits from employment. In this case the appellant an employee of the Central Bank of Ceylon took advantage of the Health Insurance Scheme under which he received payment as reimbursement of medical expenses for his mother's illness. The Supreme Court held that payment had only a remote connection with his service and the payment was in the nature of a free benefit conceded out of benevolence to employees whose personal circumstances justify assistance.

14. Rental value of free quarters provided rent free by the employer S. 4(d):

Where an employer provides a place of residence rent free or at a rent less than the rental value, the rental value or the excess of rental value over the rent paid will be regarded as profits from employment.

Rental value assessable is limited to either 15 % of the profits from employment described in paragraph 1(a) and 1(b) above or Rs. 15,000 whichever is the lower. Any excess of the rental value over these limits will be ignored.

Example I:

Mr. X was provided residence free of rent during the year ended 31.3.1982. His total remuneration was Rs. 80,000. The rating assessment of residence provided is Rs. 10,000.

Computation of Rental value:

Rating assessment	... ...	Rs. 10,000
Less: Deduct 25 % for repairs	... ...	2,500
Net Annual Value	... ...	7,500
Add: $33\frac{1}{3}$ % for repairs and expenses	...	2,500
		10,000
Add: Rates at 30 %	... ...	3,000
Rental Value	... ...	13,000
Or: Rating assessment	... ...	10,000
Add: Rates 30 %	... ...	3,000
		13,000

Since 15 % of the profits from employment is Rs. 12,000 the rental value assessable on Mr. X will be Rs. 12,000 and not Rs. 13,000.

Example II:

Assume that the rent paid by Mr. X in Example I is Rs. 9,000 then the excess of rental value over rent paid that is Rs. 3,000 will be regarded as profits from his employment.

15. **Deduction of expenses in computing income from employment.**

In computing the profits from employment no deduction other than the following can be deducted. S. 24(1)(b).

(a) Bad debts incurred. S. 23(1)(h).

(b) Contributions by an employer to a pension, provident or saving fund or to a provident or savings society which is approved by the Commissioner General S. 32(2).

16. **Bonus.**

Bonus is additional remuneration paid by the employer in addition to salaries or wages and is assessable to tax in the year of assessment in which such bonus is received. In the case of *Garforth v. Newsmith Stainless Ltd.,* a bonus vōted by a company and placed to the credit of the directors current account was treated as having been paid notwithstanding that the bonus was not actually received by the directors. The company was held liable to acount for P.A.Y.E. Tax at the time the bonus was credited to the directors current accounts.

17. **Concessionary rate of tax in respect of certain lump sum payments received by an employee as retirement benefits.** S. 32(2).[1]

Concessionary rate of tax will apply in respect of the following lump sum payments received by an employee provided such payment is in accordance with any scheme which is uniformly applicable to all individuals employed by his employer.

(a) any sum received in commutation of pension; or

(b) anu sum received as retiring gratuties; or

(c) any sum received as compensation for loss of office or employment; or

(d) any sum paid at the time of retirement from any employment from a provident fund approved by the Commissioner General excluding such part of the sum which represents the employees contributions made after April 1, 1954; or

(e) any sum paid from a regulated provident fund to an employee excluding that part of the sum which represent contributions made by the employer prior to April 1, 1968 and the interest which accrued on such contributions made by the employer, if tax at 15 % has been paid on such interest.

The rate of tax applicable to these lump sum payments are as follows: (First Schedule Part IV)

On the first	Rs. 50,000	Nil
On the next	25,000	5 per centum
On the next	25,000	10 per centum
On the balance		15 per centum

1. 24 of 1980.

Where any sum is paid to employees according to any scheme which is not uniformly applicable to all individuals employed by such employer, the concessionary rates of tax will not apply to such payment. In such circumstances the employee's taxable income and the lump sum payment will be taxed at rates applicable to individuals. S. 32(2).[1]

Retirement benefits received by the following are exempt from income tax; S. 9(1)(h).

(a) any person who holds any paid office under the Republic of Sri Lanka;
(b) Employees of any University;
(c) Employees of Public Corporations;
(d) Employees of any business undertaking vested in the Government; and

18. **Non-Citizens employed in Sri Lanka.** S. 67(7)[2]

An individual who is not a citizen of Sri Lanka and who is employed in Sri Lanka is deemed to be a non-resident for a period of three years from the date on which he commences employment in Sri Lanka. S. 67(7). The period of three years can be either one stretch of three years or in broken periods aggregating to three years.

Such a non-citizen employee by reason of his being deemed non-resident will be liable to income tax on his profits from employment and any other sources of income from Sri Lanka exceeding Rs. 1,200 at a concessionary rate of tax of twenty five percent; S. 32(1)(b) and First Schedule Part III.

Non-citizen employees who have already been granted exemption prior to November 15, 1979 will continue to enjoy exemption from income tax for the period specified in such exemption order. Non-citizen employees in the Greater Colombo Economic Commission will be exempted from income tax.

19. **Exemption of Profits and income from all sources in the aggregate Rs. 1,200 of individuals in receipt of income from employment.** S. 9(e).

Profits and income not exceeding in the aggregate of Rs. 1,200 from all sources other than from any employment received by an individual or a child whose total statutory income is aggregated with that individual is exempt from income tax, where the total statutory income of that individual consists only of –

(a) profits from employment not exceeding thirty thousand rupees; and
(b) profits and income not exceeding Rs. 1,200 from all sources, other than employment.

Where any tax has been paid by deduction or otherwise on the exempted profits of Rs. 1,200 referred to in this paragraph, in any year of assessment, the tax paid will be refunded on an application made in writing by such individual within three years of the end of that year of assessment. S. 9(1)[2]

---

1. 24 of 1980. 2. 27 of 1982

20. **Assessment of arrears of salary**: S. 115(5) [1]

The time limit of three years in respect of assessment to income tax does not apply to any arrears relating to profits from employment. Accordingly an assessment to income tax payable to any person in respect of any year of assessment of any arrears relating to profits from employment of that person can be made at any time for that year of assessment.

1 24 of 1980

Chapter 17

INCOME FROM PROPERTY

There are two sources of income from house property which are liable to income tax. They are:-

(a) Net Annual Value

(b) Rent

The income chargeable with income tax from these two sources of income is determined in a prescribed manner.

1. Net Annual Value

Where the house property is occupied by or on behalf of the owner and is not occupied for the purpose of trade, business, profession or vocation such owner is liable to income tax on the net annual value. S. 3(c). A house is considered occupied on behalf of the owner when it is kept bv the owner for his use or use by any member of his family, even though neither he nor a member of his family in fact lives in it.

The net annual value is a notional income, chargeable with income tax although no income is received by the owner. The charge of income tax does not arise where such property is occupied for the purpose of any trade, business, profession or vocation. Nor can any notional rent be deducted in computing the profits of such trade, business, profession or vocation in respect of properties occupied for these purposes by the owner.

2. Computation of Net Annual Value

The net annual value of any land and improvements or of any place of residence is determined on the basis of rent which a tenant might reasonably be expected. taking one year with another, to pay for such property on the basis the tenant pavs the rates and the owner bears the cost of repairs after deducting twenty five percent on account of repairs and other expenses. S. 5(1).

In the case of properties assessed for rates by the local authority the net annual value is determined by deducting twenty five percent from the annual. value on account of repairs and other expenses. The Annual Value is a notional value determined by the local authority for the purpose of levying rates – such a value is generally arrived at by the local authority as a sum for which that property can be let on rent taking into account the location condition and demand for houses.

Example of Computing Net Annual Value from Annual Value.

Rating Assessment (i.e. Annual Value as assessed by the local authority for rating purposes)	... Rs.	4,000
Less: 25 per cent for repairs and other expenses	...	1,000
Net Annual Value	... Rs.	3,000

The Revenue Authorities usually adopt the annual value as determined by the local authority for the purpose of levying rates as the basis for determining net annual value. However, where the Commissioner General is of opinion that the assessment made by the local authority does not accurately represent the annual value of such property he may refuse to adopt such annual value for the purpose of computing the net annual value and may determine the net annual value on the basis of the rent which a tenant might reasonably be expected to pay for such property. S. 5(2).

In the case of a house not assessed for rating purposes by the local authority the net annual value is determined on the basis of rent which a tenant is reasonably expected to pay. The Department of Inland Revenue has indicated (Tax system 1976/77) that where the property has not been rated the net annual value will be estimated at an amount not exceeding five per cent of its capital value.

3. Deductions in ascertaining Net Annual Value:

In the ascertaining net annual value no deduction other than specified deduction is permitted. Where the net annual value is computed on the basis of the annual value of the local authority a deduction of twenty five per cent on account of repairs and other expenses is allowed: S. 5(2): S. 24(3).

4. Exemption of Net Annual Value from Income Tax.

The Net Annual Value is exempt from income tax in respect of the following:

(a) **One place of residence of an individual**

The net annual value of not more than one place of residence owned by and occupied by or on behalf of an individual in exempt from income tax. S. 12(1)(a).

(b) **Newly constructed house occupied by the owner:**

The net annual value of a newly constructed house which is occupied by the owner is exempt from income tax for the year of assessment in which the construction was completed and for the six years of assessments immediately succeeding that year of assessment. S. 12(1)(b)(ii).

(c) **Property owned by a Body of Persons whose object is the promotion of sports:**

The net annual value of any property owned by a body of persons, the primary objective of which is the promotion of any sport which is recognised as a sport for the purposes of the Sports Law No. 25 of 1973 and used for that object by that body is exempt from income tax. S. 12(1)(d).

(d) **Premises or place of Public Worship:**

The net annual value of any place of public worship and its premises administered by such institution is exempt from income tax. The exemption also covers any place or premises owned and occupied by such institution solely for any of the purposes of that institution. S. 8(d)(ii)(a) and (b).

5. Income from rent

Income from letting of properties on rent is a separate source of income chargeable with income tax and is determined in a prescribed manner. In the case of a business carried on by any person, including a Company, of letting out properties owned on rent, the source of income under which the charge of income tax arise is rent and is not income from a trade or business. In view of this position no deductions in respect of any outgoings and expenses, other than the prescribed deductions can be claimed. The only exception however, is that in the case of a company carrying on the business of letting "Commercial buildings" can deduct all out goings and expenses incurred in connection with this business of letting, in computing its profits for tax purposes: S. 24(3): but repairs expenditure shall not exceed ten percent of Gross-rent. S. 23(1)(g).

Where the owner receives payment for providing services, additional facilities or hire of furniture etc. such income will be chargeable with income tax as income from trade or business and all outgoings and expenses can be claimed in computing such profits. Since such income is not rent for letting property, there is no prohibition of deduction of expenses other than the prescribed deductions. It is advisable for the owners to levy rent and service charges separately so that the cost of providing the additional facilities can be claimed as an outgoing and expense in respect of a business of providing services or other additional facilities.

6. Computation of Income from Rent in respect of properties other than Commercial Buildings

The charge to income tax on rent income is on the gross amount receivable and can be recovered after deducting –

(a) rates borne by the owner; and

(b) a deduction of 25 % of the balance after deduction of rates, towards repairs.

(c) Payments, if any, to the Repairs Fund.

The expenditure on repairs is permitted to be deducted on the basis that the owner bears the cost of repairs and is allowed irrespective of whether or not the repairs are carried out. No further deductions other than these deductions can be made in computing the income from rent. S. 24(3).

7. Minimum Amount assessable as Rent

The minimum amount assessable as rent shall not be less than Net Annual Value. The net annual value is based on the rent that particular property will command and will thus be the minimum amount assessable as rent.

However, adjustments are made in computing rent in respect of the following:-

(i) the amount which is deemed to be occupiers income,
(ii) the rent for the period during which the rent cannot be recovered.
(iii) the rent receivable for period during which the property is vacant.
(iv) In cases where the authorised rent under Rent Restriction Law is less than Net Annual Value.

Example I:

A house in the city of Colombo was let at an annual rent of Rs. 3,000. The rating assessment of the property as assessed by the Municipal Council is Rs. 1,000. The rates paid by the owner is Rs. 300.

Computation of income from rent:

Gross rent	Rs.	3,000
Less: Rates		300
		2,700
Less: 25% allowance for repairs		675
Income from rent	Rs.	2,025

Example II:

A house in city of Colombo was let by the owner at an annual rent of Rs. 5,000. The annual value as assessed by the Colombo Municipal Council was Rs. 4,000. The rates by the owner was Rs. 1,200.

Computation of income from rent:

Gross rent	Rs.	5,000
Less: Rates paid by the owner		1,200
		3,800
Less: 25% deduction for repairs		950
Income from rent	Rs.	2,850

Computation of Net Annual Value:

Rating Assessment	Rs.	4,000
Less: Deduction of 25% for repairs		1,000
Net annual value	Rs.	3,000

Since the income assessable as rent shall not be less than the net annual value, the owner will be liable on Rs. 3,000 as the income from rent.

Example III

A house in the city of Colombo was let to Mr. X at an annual rent of Rs. 4,000. The rating assessment of the house as assessed by the Colombo Municipality is Rs. 6,000. Rates paid by the owner is Rs. 1,800.

Computaion of income from Rent:

Gross Rent	Rs	4,000
Less: Rates paid by the owner		1,800
		2,200
Less: 25% deduction for repairs		550
Income from rent	Rs.	1,650

Computation of Net Annual Value:

Rating assessment	...	...	... Rs.	6,000
Less: 25 % deduction for repairs		...	...	1,500
Net annual value ...		...	... Rs.	4,500

Since the owner is receiving rent less than net annual value adjustment will be made in respect of occupier's income, and the liability will be on the following basis:

Occupier's Income:

Net Annual Value	...	...	... Rs.	4,500
Rent paid by occupier	...	...	...	4,000
Occupier's Income	...	...	... Rs.	500
Owner's Income				
Net Annual Value	...	...	... Rs.	4,500
Occupier's Income	...	...	...	500
Owner's Income from rent		...	... Rs.	4,000

Example IV

A house in the city of Colombo was let on a rental of Rs. 12,000 per annum. The owner paid the rates amounting to Rs. 1,200. The annual value as assessed by the Colombo Municipality was Rs. 4,000. The contribution by the owner to the Repairs Fund was Rs. 1,200.

Computation of Income from Rent:

Gross rent ...	...	...	... Rs.	12,000
Less: Repairs fund payments	...	Rs. 1,200		
Rates paid by the owner ...	...	1,200		2,400
			Rs.	9,600
Less: 25 % deduction in respect of repairs			...	2,400
Income from rent	...	...	...	7,200

Example V

A house in the city of Colombo was let at a monthly rent of Rs. 400 per month. The annual value as assessed by the Colombo Municipality is Rs. 5,000. Rates paid by the owner Rs. 1,500. The owner could not recover rent from the tenant for three months.

Computation of Rent Income:

Gross rent received 9 × 400	...	... Rs.	3,600
Less: Rates paid by owner	...	...	1,500
			2,100
Less: Deduction for repairs – 25 %	...	...	525
Income from rent ...	...	... Rs.	1,575
Net annual value			
Annual value as assessed by the Municipal Council		... Rs.	5,000
Less: Deduction for repairs 25 %	...	...	1,250
Net annual value ...	...	... Rs.	3,750

Since net annual value exceeds rent Income, adjustment will be due in respect of occupier's Income

Occupier's Income				
Net annual value	...	...	... Rs.	3,750
Rent paid	...	...	...	3,600
Occupier's Income	...	...	... Rs.	150
Owner's Income	...	...		
Net annual value	...	...	... Rs.	3,750
Occupier's Income	...	...	...	150
Income from rent	...	...	... Rs.	3,600

8. Companies Carrying on the Business of letting Commercial Buildings

The word "Business" has been defined to include the letting of commercial premises by a limited liability Company. S. 163. Therefore, the source of income of a company receiving rent from letting of commercial premises would be profits of a business and not income from rent. Accordingly a company letting commercial buildings can deduct all outgoings and expenses incurred in carrying on the business of letting commercial buildings in computing its profits, However, a deduction on account of any expenditure on repairs to any plant, machinery, fixtures, buildings, implements, utensils or articles employed for the purpose of producing the income of a company letting premises for commercial purposes shall not exceed ten percent of the gross rent recievable by such company for such premises. S. 23(g).

9. Letting part of the business premises

Where the premises are occupied by the owner for the purposes of a trade, business, profession or vocation the net annual value is not chargeable with income tax on the owner. In computing the profits of such trade, business, profession or vocation no deduction of a notional rent can be made.

Where part of the premises are either used for residential purposes or given out on rent an apportionment of the rates paid on some reasonable basis, for example on the basis of floor area must be made.

Example:

Mr. A owned a building the square area of which is 10,000 sq. ft. The Company let part of the premises extent of 2,000 sq. ft. for Rs. 20,000. The rates paid by the company for entire premises is Rs. 4,000.

Computation of Income from rent of Mr. A:

Gross rent ...	...	...	... Rs.	20,000
Less: Rates: $\frac{5,000}{10,000} \times 4,000$	...	...	...	2,000
				18,000
Less: 25 % for repairs	...	...	...	4,500
Income from rent	...	...	... Rs.	13,500

10. Exemption of Rent from Income Tax in respect of certain houses

Exemption from income tax is available in respect of the income from newly constructed houses or income from houses by conversion of a house which did not qualify for exemption into two or more places of residence.

(A) **Newly Constructed houses.** S. 12(1)(b)

Income accruing to the owner of a newly constructed house qualifies for exemption from income tax if –

(a) such house is used solely for residential purposes, and

(b) the Rent Act No. 7 of 1972 applies to such a house, or

(c) has a floor area, inclusive of the thickness of the walls, which does not exceed 3,000[1] square feet

The period during which the exemption from income tax is determined on the basis of the floor area of such house and applies as follows.

(ii) **Where the floor area of the house does not exceed 3,000 sq. ft.**

Where the floor area of such a house does not exceed 3,000 sq. ft. including the thickness of the walls the income from such house is exempt from income tax for the year of assessment in which such house was completed and for the six years succeding that year of assessment.

(ii) **Where the floor area is 1,500[1] square feet or less**

Where the floor area of the house is one thousand five hundred square feet or less the income from that house will be exempt from income tax for the year of assessment in which the construction of the house is completed and for the nine years of assessment succeding that year of assessment.

The provisions of the Rent Act No. 7 of 1972 do not apply to houses constructed after January 01, 1980. The entire income from such a house will be exempt from income tax.

(B) **Conversion of existing house into two or more places of residence.** S. 12(1)(c)

Where a house which was not eligible for exemption is converted into two or more residential premises and each such place of residence is being separately assessed for the purpose of rates, the income arising from rent of such place of residence is exempt from income tax. The period of exemption is on the basis of the floor area of such place of residence:

(i) Where the floor area does not exceed 1,000 square feet the rent income is exempt for the year of assessment in which conversion was effected and for five years of assessment immediately succeeding that year of assessment;

(ii) Where the floor area exceeds one thousand square feet but does not exceed two thousand square feet the rent income is exempt for the year of assessment in which conversion was

1. 40 of 1981

effected and the three years of assessment immediately succeeding that year of assessment.

The exemption is available on the production of a certificate from the Commissioner of National Housing specifying the following details:

(a) the date of completion of construction or the date of conversion into two or more places of residence; and

(b) the floor area inclusive of the thickness of the walls of a newly constructed house or the floor area of the places of residence obtained by conversion of a house. S. 12(2).

A certificate issued by the Commissioner of National Housing will be required as evidence in support of claim for exemption from income tax. Such a certificate should specify the following details – S. 12(2)(a).

(a) the date of completion of construction or the date of conversion into two or more places of residence; and

(b) the floor area inclusive of the thickness of the walls of newly constructed houses or the floor area of the places of residence obtained by the conversion of a house.

Chapter 18

INCOME FROM INTEREST

Interest is a source of income chargeable with income tax under Section 3(e) of the Inland Revenue Act. Income arising from interest shall be the full amount of interest falling due whether received or not, without any deduction for outgoings or expenses. S. 23(4). However, in the case of business of money lending the profits of such business will be considered as profits of a trade or business and will be assessable under section 3(a) and in computing such profits all outgoings and expenses can be deducted and the prohibition of deductions in computing income from interest will not apply: *The Ceylon Financial Investment Co. v. C.I.T.*, 1 CTC 206: *C.I.T. v. R.M.A.R.A.R.R.M.* 1 CTC 37: *Hakim Bhai v. C.I.T.* 1 CTC 8.

> "If it is a case of dividends, interest or discounts, appertaining to a business, they fall within the words "profits of a business" and section 6(1)(a) applies. If, however, it is a case of dividends interest or discounts accruing to an individual not, in the course of a business, then section 6(1)(e) is the relevant section ...... As I have already submitted dividends and interest may well be the income of an individual from simple investments, and sub-section (3) is careful to enforce a disallowance in regard to interest that is part of income but not in regard to interest that is part of profits" – Soertsz J. in 1 CTC p. 252 & 253.

The section 6(1)(a), 6(1((e) and sub-section (3) referred to are similar to section 3(a), 3(b) and 23(4) of Inland Revenue Act.

1. Accrued Interest

Except in special cases, where the owner of an interest bearing security sells it between the fixed dates upon which the interest is payable, the accrued interest at the time of sale will be represented in the price unless at the time of sale the security is marked in the official list as "ex-interest". For income tax purposes interest arises as income only at the respective dates when payments which have fallen due are made, and that the whole of the interest then paid is the income of the person legally entitled to payments. Where the sale price is expressed as a capital sum plus interest computed from the last date of payment, such amount of interest is not assessable in the hands of the seller; the purchaser is assessable on the whole amount of the interest received by him on the next due date and cannot claim any deduction in respect of interest contained in the purchase price.

The truth is that the seller does not receive "interest" from the buyer and it is interest which is the subject matter of the taxation. He receives the price of the expectancy of interest, and that is not the subject matter of taxation". – Rowlatt J. in *Wigmore v. Thomas Summerson & Sons Ltd.*, 9 TC 577.

2. **Interest awarded in legal proceedings**

The distinction whether a sum awarded is interest or damages will depend on the substance and not on the mere term interest. Where a sum is received by way of interest under a contract, award or decree is interest income – *Schulze v. Bensted;* 7 TC 30; An amount which reaches the hands of the recipient as interest upon a principal sum is interest upon a principal sum notwithstanding that the sum has come to him as a single sum as a result of a hostile suit: *Westminster Bank Ltd. v. Riches* – 28 TC 159. On the other hand, where the sum received is not interest proper, but is interest by way of damages, the case falls within one of the two categories: (a) the "interest" which is in reality damages may still be income in nature and is taxable or; (b) the calculation of interest may be used as a means of arriving at a capital sum of damages, in which event it will not be taxable.

3. **Capitalisation of Interest**

The following features may exist:

(a) a mortgage containing a clause for capitalisation of interest on non-payment;

(b) failure to pay the interest, thus calling into effect the capitalisation clause;

(c) subsequent payment out of capital moneys.

Capitalisation of interest by a mortgagee is not a payment of interest. but that when the debt is subsequently discharged or reduced by actual payment then any sum actually paid in respect of "capitalised" interest on the original loan is payment of interest: *I. R. Commissioners v. Oswald,* 26 TC 435.

The practice of banks to add interest to principal at half-yearly rests does not constitute, as between the bank and its customer, a payment of interest by the customer for any purpose: *Paton v. I. R. Commissioner,* 21 TC 435.

Where interest under a mortgage bond is added, as it falls due, to the principal debt, does not constitute payment of interest. In the words of Lord Simonds: 26 TC 435:

"The question in the simplest terms is whether, when the mortgagee capitalises interest, the mortgagor pays it; and the answer, in terms as simple, is that the mortgagee capitalises it just because the mortgagor does not pay it. It is not a form of payment: It is not a substitute for payment: the interest remains unpaid, but it is impressed with a new quality, viz., that it carries interest as it were capital. The interest was always charged on the security; it adds nothing to speak of it as a capital charge. I will assume that a mortgagee may accept in full satisfaction of interest something that is not money but money's worth. But that assumption does not justify the further step in the reasoning of the Court of Appeal that capitalisation of interest is payment of interest."

4. Basis of assessment of income from interest

The income arising from interest is the full amount of interest falling due, whether received or not. Thus the full amount of interest receivable during an year of assessment is chargeable with income tax.

5. Measure of assessment of interest S.23(4)

The amount of income from interest chargeable with income is the full amount of interest falling due whether received or not. There are of course difficulties that may arise when an amount of interest receivable is charged with income tax is found to be irrecoverable. In order to provide for relief against any hardship on assessment of interest receivable and to provide against loss of revenue on interest excluded from the assessment certain measures have been provided.

These measures are:-

(a) Where any interest falling due in respect of a loan in any year of assessment has not been received or is likely to be irrecoverable, the person to whom the interest is due may exclude such interest from the profits and income chargeable for that year of assessment.

(b) Where an amount excluded from an assessment under (a) above has been subsequently received, the Assessor is empowered to make an additional assessment although such assessment may be prescribed.

(c) Where any interest is unpaid and cannot be recovered and has been included in any assessment, such assessment be reduced by the amount of the interest unpaid and irrecoverable.

(d) Where tax has been paid in respect of such 'interest' such tax may be refunded on a claim made in writing within three years of the end of the year of assessment in respect of which tax was paid.

It must be noticed that where an assessment has been made in respect of any interest receivable, the law provides for only the reduction in the assessment and does not provide for the issue of refund of the tax paid in excess. Therefore, refund if any, arising as a result in the reduction in the assessment will be prescribed unless a claim in writing has been made within three years of the end of the year of assessment in respect of which the assessment was reduced.

In cases where an assessment has been made including an amount of interest receivable in respect of which tax has been paid it is advisable to make a formal claim for refund where there is any likelihood of such interest becoming irrecoverable.

6. Exemption of certain income from Interest. S. 10.

The following income from interest is exempt from income tax:-

(a) **Interest on Ceylon Savings Certificates**

Accumulated interest payable to an individual in respect of Ceylon Savings Certificates purchased by that individual on or before 15th November 1978 is exempt from income tax: S. 10(a).

(b) **Interest on Deposits in the National Savings Bank and on National Savings Certificates purchased after 15.11.1978.**

Interest income up to Rs. 2,000 or one third of the total interest income whichever is higher in respect of interest received on:-

(i) National Savings Certificates purchased after November 15, 1978 and,

(ii) Moneys lying to the credit of such individual in the National Savings Bank. S. 10(b).

This exemption will apply in respect of interest income of every child whose income is assessed with that of the parent.

(c) **Interest income of certain foreign agencies which are approved by the Minister of Finance.** S. 10(c).

Interest accruing to any company, partnership or other body of persons outside Sri Lanka from any loan granted to:

*(i) The Government of Sri Lanka; or

(ii) Any Public Corporation; or

(iii) Any Government institution; or

(iv) Any Commercial Bank operating in Sri Lanka; or

(v) Any other undertaking if such loan is approved by the Minister of Finance to be essential for the economic progress of Sri Lanka. S. 10(c).

(e) **Exemption of interest accruing to a non-resident on moneys lying to his credit in foreign Currency in Sri Lanka.** S. 10(e).

Interest income accruing to any person in respect of moneys lying to his credit in foreign currency in any account opened by him or on his behalf in any Commercial Bank with the approval of the Central Bank of Ceylon is exempt from income tax during the period in which such person is non-resident in Sri Lanka and for a period of three years from the date on which he commences to be resident in Sri Lanka. S. 10(e)[1]

(d) **Interest on amounts lying in Special Accounts in Commercial Banks made out of foreign Currency remittances.**

Interest accruing on moneys lying to his credit in Special Accounts in a Commercial Bank opened with the approval of the Central Bank of sums obtained by the exchange of foreign currency held by him outside Sri Lanka, in accordance with the conditions imposed by the Central Bank is exempt from income tax. The exemption will apply to every person, i.e. individuals, companies etc.

(f) **Interest on Tax Reserve Certificates**

Any interest forming part of the surrender value of any tax reserve certificate is exempt from income tax. S. 10(f).

---

1. 27 of 1982.

(g) **Interest on moneys lying to his credit in Foreign Currency Banking Unit**

Interest income accruing to any person on moneys lying to his credit in Foreign Currency Banking Unit is exempt from income tax. S. 10(g).[1]

A foreign Currency Banking Unit means a unit or department of a commercial bank authorised by the Central Bank of Ceylon to operate as Foreign Currency Banking Unit. S. 163.[1]

7. **Deduction of income tax on interest receivable by persons outside Sri Lanka**

Where a person out of Sri Lanka receives interest on debentures, mortgages, loans, deposits or advances, that amount of interest will suffer deduction of income tax at $33\frac{1}{3}$ % or any other rate as is prescribed by the Commissioner General of Inland Revenue. S. 81(1). The deduction will be made by the person in Sri Lanka who is paying the interest to such person out of Sri Lanka. The scheme of deduction of tax is that it will usually be a once and for all tax due on the interest income of the non-resident. However, if the amount of interest which has suffered deduction of income tax is included in the assessable income of the non-resident person, then he is entitled to a set off to the extent of the tax so deducted. S. 81(3).

A person deducting tax on the interest is required to issue a certificate giving the following details:-

(a) the gross amount of the payment or credit;
(b) the rate and amount of the tax so deducted; and
(c) the net amount actually paid or credited.

This certificate will serve as evidence of tax having been deducted and will entitle the person to a set off, if the amount of interest is included in the assessable income of that person.

The requirement of deduction of tax on interest payments to any person out of Sri Lanka does not apply to

(a) interest paid out of income not arising in Sri Lanka;
(b) interest on any loan or advance made by the banker; and
(c) interest paid by a Foreign Currency Banking Unit.[1]

8. **Interest on certain loans deemed to be profits**

Where interest is payable to a non-resident person on a loan obtained from such person and the interest on such loans is borne –

(a) directly or indirectly by a person resident in Sri Lanka; or
(b) by a non-resident person where the amount of such loan or part thereof has been brought to or used in Sri Lanka; ;

such interest shall be deemed to be profits and income arising in or derived from Sri Lanka. S. 80 A.[2]

---

1. 24 of 1980 2. 40 of 1981.

The gross interest, which is not exempt from income tax and which is deemed to arise in Sri Lanka to a Company, Partnership or Body of Persons outside Sri Lanka on loans granted by them to any person in Sri Lanka is chargeable with income tax at fifteen percentum. S. 32 C.[1]

9. Interest on Compensation payable by Government, Land Reform Commission, Public Corporation or Local Authority. S. 32 A[1].

Accumulated interest receivable on compensation in respect of movable or immovable property vested in the Government, or the Land Reform Commission, or a Public Corporation, or a Local Authority is deemed to be income to that person in the year of assessment in which such interest is received. The entire amount of interest which accrues to that person from the date such compensation accrued due to the date on which such interest actually paid is chargeable with income tax in the year of assessment in which such payment is received and not in the year of assessment to which such interest relates. S. 32 A(2).

The rate of income tax which such interest is chargeable is ten percent. The tax due will be deducted by the relevant authority at the time of the payment of accumulated interest and remitted to the Commissioner General of Inland Revenue. The authority deducting the income tax on such interest shall furnish a statement giving particulars of:

(a) the Gross amount of interest paid;
(b) the tax deducted;
(c) net amount paid;
(d) Name and the address of the person to whom such interest was paid.

The amount of the interest deducted at the time of payment shall be set off against the income payable by such person on the accumulated interest received. S. 32 A(2)(b).

A Public Corporation, for this purpose is defined as any Corporation, Board or other Body which was or is established by, or under, any written law, other than the Companies Ordinance, with Capital wholly or partly provided by the Government, by way of grant, loan or other form.

10. Accumulated interest payable by banking institutions on certain deposits. S. 32 B.[1]

The accumulated interest on a sum of money deposited in a banking institution by any individual or by another person on behalf of any individual will be liable to income tax at a concessionary rate of tax of fifteen percentum. The concessionary rate of tax will apply provided that such deposit scheme is;

(a) operated by a banking institution;
(b) approved by the Commissioner General;
(c) conforms to such conditions as may be specified by the Commissioner General from time to time. S. 32 B(1).

---

1. 27 of 1982.

'Taxation 1981/82' issued by the Department of Inland Revenue indicates that this concession will cover schemes like the Minors Extended Deposit Scheme.

The interest paid to any individual from such deposits shall be deemed to be income arising to him in the year of assessment in which such interest is paid and not in the year of assessment to which such interest relates. Thus, the interest accruing year by year does not form income in those years and is chargeable only in the year of assessment in which it is paid:

The rate of income tax payable shall be;

(a) fifteen percentum; or

(b) the maximum rate at which he is liable to pay income tax on income excluding interest received on the deposit.

Whichever is the lower rate: S. 32 B(2)(a).

The banking institution, however, shall deduct from such interest income tax at fifteen percent when paying the interest and shall remit the tax so deducted forthwith to the Commissioner General of Inland Revenue. 32 B(2)(b). The banking institution shall issue a statement in writing setting out the following:

(a) Gross amount of the interest paid;

(b) the rate and amount of tax deducted;

(c) the net amount paid. S. 32 B(2)(c).

Where a banking institution fails to deduct income tax on such interest, then the Director, General Manager or other principal officer of such banking institution shall be personally liable for the tax that ought to have been deducted and may be recovered from such director, manager or principal officer.

Refund tax deducted:

Where the individual who receives the interest is not liable to income tax or where the maximum rate at which he is liable to income tax is less than fifteen percentum, be shall be entitled to a refund of

(a) the tax deducted if he is not liable to income tax;

(b) the difference between fifteen percent and the relevant lower rate of tax applicable to him for that year of assessment.

The refund shall be made only on production of the certificate of deduction of tax from the banking institution. The claim for refund must be made within three years of the end of the year of assessment in which such interest was received. S. 32 B(2)(d)(ii).

Additional Assessments:

Where money is deposited in a banking institution under a scheme approved by the Commissioner General and such individual withdraws the interest on such money in contravention of the conditions imposed by the Commissioner General in respect of such scheme, additional assessments may be made in respect of every year of assessment to which the interest so withdrawn relates. S. 32 B(4).

Chapter 19

DIVIDENDS

Dividend is a source of income liable to Income Tax. A dividend is a distribution of profits by a company to its shareholders in the form of –

(a) money or an order to pay money; or

(b) shares in any other company; or

(c) debentures in that company or in any other company; and

(d) the amount of capital returned or distributed to the extent of the paid up value of any bonus shares within six years from the date of issue of bonus shares by capitalisation of profits. S. 163.

1. Exemption from income tax in respect of dividends received from certain companies. S. 11.

Dividends received by shareholders from certain companies are exempt from income tax. The exemption applies to dividends declared and paid out of the profits of the company which are exempt from income tax. The exemption of dividends will apply to the following category of companies.

(a) Companies in the Investment Promotion Zone;

(b) Companies which are entitled to exemption from income tax in respect of certain undertakings carried on by them.

(a) Companies in the Investment Promotion Zone

Any dividend paid by a company with which an agreement has been entered into by the Greater Colombo Economic Commission under section 17 of the Greater Colombo Economic Commission Law No. 4 of 1978 is exempt from income tax.

The exemption will apply to a dividend paid;

(i) to any person who is not resident in Sri Lanka;

(ii) to any person out of the profits and income of that company which are exempt from income tax during the period for which such company is exempt in terms of the agreement or within one year thereafter. S. 11(a).

(b) Companies which are entitled to exemption from income tax in respect of certain undertakings carried on by them.

The exemption from income tax will apply to dividends paid to shareholders:

(a) out of the profits and income arising on or after April 1, 1977 which are exempt from income tax;

(b) such dividend being paid out of the exempt profits and income during the period for which such profits are exempt from income tax or within one year thereafter.

The profits of undertakings carried on by companies which are exempt from Income Tax and can declare tax free dividends are:

(a) Profits of an undertaking from the sale of gems to the State Gem Corporation. S. 15(a).

(b) Income arising to a company from any investment made with the approval of the Central Bank of Ceylon with moneys lying to the credit of a special account of sums obtained by the exchange of foreign currency held outside Sri Lanka. S. 15(b).

(c) Profits of an undertaking by a resident company which carries on or exercises any trade or business in the course of providing professional services or carrying on a construction project. S. 15(cc).[1]

(d) Profits and income from the sale of gems on or after November 15, 1979 at any gem auction conducted by the Ceylon Chamber of Commerce. S. 15 (l).[2]

(e) Profits and income from export of gems on or after November 15, 1979. S. 15(m).[2]

(f) Profits and income of a company authorised to accept foreign currency from sale on or after November 15, 1979 of gems and jewellery as are received by such company in foreign currency. S. 15(o).[2]

(g) Profits and income to the consignor or consignee from export or or after November 15, 1979 of

(i) any precious stones or metals not mined in Sri Lanka;

(ii) any petroleum products;

(iii) any other products approved by the Minister,

being stones, metals or products brought on consignment basis and re-exported without subjecting to any process or manufacture. S. 15(p).[2]

(h) Profits and income of companies approved before March 31, 1983 carrying on an undertaking for the operation of hotels for tourists or an undertaking for providing building for the operation of hotels for tourists. S. 16.

(i) Profits and income of a quoted public company carrying on tourist hotels incorporated after November, 15, 1979 and approved before March 31, 1983 with an qeuity capital of not less than Rs. 100 million. S. 16 A.[2]

(j) Profits and income of companies carrying on tourist hotels approved before March 31, 1983 which constructs additional rooms after November 15, 1979. S. 16 B.[2]

(k) Profits and income of companies approved before March 31,

1. 27 of 1982 2. 24 of 1980.

1983 engaged solely in carrying on one or more of the following:

(i) off shore and deep sea fishing;

(ii) cultivation of land with any plants of whatever description other than tea, rubber, coconut or paddy;

(iii) animal husbandry;

(iv) carrying on any activity in paragraphs (i) and (ii) above and processing of the product of such activity. S. 17.

(l) Profits and income of companies carrying on certain small scale undertakings for the production or manufacture of commodities. S. 18.

(m) Profits and income of companies carrying on an undertaking for the milling of paddy. S. 19.

(n) Profits and income of companies approved before March 31, 1983 carrying on an undertaking for the manufacture and export of certain commodities or of providing services for payment in foreign exchange. S. 21.

(o) Profits and income of companies carrying on an undertaking for the construction and first sale of houses. S. 21

(p) Profits and income of quoted public companies approved before March 31, 1983 carrying on contracts with the Mahaveli Authority. S. 22 A.[1]

(q) Profits and income of companies approved before March 31, 1983 carrying on an undertaking in property development. S. 22B.[1]

(r) Profits and income of companies approved before March 31, 1983 undertaking pioneering industries. S. 22C.[1]

(s) Profits and income of quoted public companies carrying on undertakings and approved before March 31, 1983 engaged in cultivation of land with certain plants. S. 22 D.[2]

2. **Dividend income of a company which is a shareholder of another resident company.**

The dividends received by a resident company or by a non-resident company from any resident company is deemed not to form part of the assessable income of the company receiving the dividends provided

(a) the tax on dividend at 20% has been deducted by the company which paid the dividend; or

(b) that the dividend is exempt from income tax; or

(c) that the dividend was paid by a company out of the dividend it received from another resident company. S. 35.

(d) the company which paid the dividend is a quoted public company. S. 35.[1]

---

1. 24 of 1980 2. 40 of 1981.

3. **Dividends which have been deemed distributed by the Assessor in respect of certain Private Companies.** S. 39(5).

Dividend which has been distributed by an Assessor does not suffer deduction of tax at 20%. Where an Assessor has deemed the profits of a company as distributed, the company is liable to pay income tax for that year of assessment at the highest rate at which an individual is chargeable for that year of assessment.

4. **Treatment of Dividend in the hands of shareholders.**

Income from dividends assessable to income tax is the gross amount of the dividends. No deduction in respect of any expenses is permitted in arriving at the amount of the dividends assessable to income tax. The year of assessment in which the dividend income is assessable is determined on the basis of the date on which the dividend is declared by the company.

The tax deducted on the dividend is an advance payment of income tax and the shareholder is entitled to a set off of tax so deducted in determining the tax payable by him. S. 38(4). Where there is no liability to income tax, the taxpayer is entitled to a refund of the tax deducted on the dividends.

Where tax has not been deducted on the dividends because the dividend formed part of the dividend received from another company, or the dividend was issued tax free, the statutory income from dividend is arrived at by increasing such dividend by twenty five percent. S. 38(3).[1] The taxpayer is entitled to a set off of tax amounting to 20 % of the gross amount. Example of various types of dividends are considered below.

Example I

Mr. Perera received Rs. 16,000 as dividend on his shareholdings in XYZ Ltd., on 30.09.1982. The dividend warrant counterfoil contained the following details:

Gross dividend	...	...	... Rs.	20,000
Less: Tax deducted – 20 %		...	...	4,000
Net dividend	...	...	... Rs.	16,000

Mr. Perera is married and lives with his wife and has no children. He does not have any other sources of income.

Computation of Repayment for year of Assessment 1982/83

Dividends	...	...	... Rs.	20,000
Less: Tax free allowance				12,000
Taxable Income			Rs.	8,000
Income Tax Payable 4,800	@ $7\frac{1}{2}$ %		...	360
3,200	@ 10 %		...	320
			Rs.	680
Less: Tax deducted on dividends		...	...	4,000
Tax Repayable	...	...	... Rs.	3,320

1. 24 of 1980.

Example II

Assume that the details of income from dividends is same as in Example I and that Mr. Perera is also in receipt of income from profession amounting to Rs. 20,000.

Computation of liability for year of assessment 1982/83

	Profession	...	...	... Rs.	20,000
	Dividends	...	...	...	20,000
	Statutory Income	...	...	... Rs.	40,000
Less:	Tax free allowance	...	...	...	12,000
	Taxable Income	...	...	... Rs.	28,000
	Income Tax Payable	4,800	@ $7\frac{1}{2}$ %	...	360
		4,800	@ 10 %	...	480
		4,800	@ 15 %	...	720
		4,800	@ 20 %	...	960
		4,800	@ 25 %	...	1,200
		4,800	@ 30 %	...	1,440
	Gross Income Tax Payable		...	... Rs.	5,160
Less:	Tax deducted on dividends		...	...	4,000
	Income Tax Payable		...	... Rs.	1.160

Example III

Treatment of dividends which includes dividend declared out of Income exempt from income tax.

Mr. X received a dividend of Rs. 9,800 from XYZ Ltd., The dividend warrant counterfoil contained the following particulars:

	Dividend declared out of Exempt Income		... Rs. 5,000
	Dividends declared out of trade profits Rs.	6,000	
Less:	Tax deducted – 20 %	1,200	4,800
			Rs. 9.800

The statutory income from dividends of Mr. X will be Rs. 6,000. He will be entitled to a tax credit of Rs. 1,200 or refund of Rs. 1,200 if he is not liable to income tax.

Example IV

Dividends declared out of dividends received from another resident Company.

Mr. Y received a dividend of Rs. 30,000 from YZ Ltd. The dividend warrant contained the following details:

	Gross dividend	...	... Rs. 30,000	
Less:	Tax at 20 %	...	... 6,000	24,000
	Dividend distributed out of dividend received from another resident company which is not a Quoted Public Company	...	...	6,000
	Net Dividend	...	...	Rs. 30,000

Computation of Statutory Income from Dividend

	Net Dividend	Rs. 30,000	
Add:	25 %	7,500	
	Statutory Income from Dividends ...	Rs. 37,500	
	Taxpayer will be entitled to a tax credit at 20 % of Rs. 37,500 = Rs. 7,500		
OR	Gross Dividend received ...		... Rs. 30,000
Add:	Dividend distributed out of a dividend received from another resident Company which is not a Quoted Public Company	Rs. 6,000	
Add:	25 % thereof	1,500	7,500
	Statutory Income from Dividends ...		... Rs. 37,500

The taxpayer is entitled to a tax credit of 20 % of Rs. 37,500 = Rs. 7,500 (that is Rs. 6,000 + Rs. 1,500)

Example V

Dividends received in the form of shares or debentures

Mr. X received 300 shares of Rs. 10 each in the form of dividends in XYZ Ltd. The statutory income of Mr. X will be Rs. 3,000 and the taxpayer will be entitled to a tax credit of Rs. 600.

Example VI

Tax free Dividend

Mr. X held 200 shares of Rs. 10 each in ABCD Ltd. He received a tax free dividend of 10 % amounting to Rs. 2,000. His statutory income from dividends is:

	Gross dividend	Rs. 2,000
Add:	25 % thereof	500
	Statutory Income from Dividend ...	Rs. 2,500

The taxpayer will be entitled to a tax credit of Rs. 500.

5. **Dividends declared to a shareholder by a company out of dividends it received from another resident company whose profits are exempt from income tax.**

Where a company declares a dividend out of an exempt dividend received from another resident company which is exempt from income tax, the company paying the dividend is not required to deduct tax.

As from November 15, 1979 dividends declared out of exempt dividends received by a company are exempt from income tax in the hands of the shareholders provided such dividend is paid out in the year in which the exempt dividends were received or within one year thereafter. S. 11(c).[1]

1. 24 of 1980.

Chapter 20

CAPITAL GAINS

The axiom that 'income tax is a tax on income' has ceased to be in vogue with the introduction of income tax on capital gains arising on the change of ownership of property and on certain type of transactions as from 1st April 1957. Capital gains is profits of a capital nature deemed to be income for the purpose of liability to income tax. S. 3(h).

The amount of the capital gains that is chargeable with income tax is the net capital gains, which is the excess of capital gains over capital loss. Capital gains or capital loss is realised on the date on which the change of ownership occurs and are computed in a prescribed manner. Certain sources which give rise to capital gains do not give rise to capital loss. A capital loss which cannot be set off against the capital gains in an year of assessment can be carried forward and set off against the capital gains arising at a future date. A capital loss cannot be set off against other sources of profit or income. except on death of an individual or when a company is liquidated.[1]

The capital gains of an individual and a small company are taxed in the progressive rate structure and relief is provided by limiting the maximum rate of tax on capital gains at twenty five percentum. S. 32(3) & 33(1B).[1]

1. Distinction between Capital Gains and profits from adventure in the nature of trade

The difference in the rate of tax applicable to Capital Gains and to profits from an adventure in the nature of trade will make it important to distinguish these two sources of income. The maximum rate at which capital gains is chargeable with income tax is twenty five percent, while in the case of individuals the highest marginal rate of tax on other sources of income is fifty five percent in the progressive tax rate structure. In the case of companies the rate of income tax is fifty percent while the quoted public companies are liable at forty percent. In the case of individuals and a small company where the taxable income including the capital gains is taxed at rates less than twenty five percentum capital gains may suffer tax at rates less than twenty five percentum. It is therefore of advantage to examine the distinction between profits of an adventure in the nature of trade or capital gains.

The character and the circumstances of the particular transaction will indicate with definitness that certain profits are profits of an adventure in

1. 40 of 1981.

the nature of trade or are capital accretions to an investment. All the relevant facts attaching to the transaction must be considered and the total impression examined to come to the conclusion as to the source under which the resulting profits are assessable. The decided cases throw some guidelines in distinguishing whether the profits are profits from adventures in the nature of trade or capital accretions. The distinction will largely depend on the nature of use, the asset is employed.

"The determining factor must be the nature of the trade in which the asset is employed. The land upon which a manufacturer carries on his business is part of his fixed capital. The land with which a dealer in real estate carries on his business is part of his circulating capital. The machinery with which a manufacturer makes the articles that he sells is part of his fixed capital. The machinery that a dealer in machinery buys and sells is part of his circulating capital as is the coal that a coal merchant buys and sells in the course of his trade. So too, is the coal that a manufacturer of gas buys and from which he extracts his gas."

Romer L. J. in *Golden Horse Shoe (New) Ltd. v. Thorgood* 18 TC 280.

Where a person realize a capital asset held by him as an investment the profit realsed is capital profits, while where the sale is in the course of trade or business it is profits of trade or business. The question that may be asked in determining whether the profits is capital accretion or income from trade is "Is the article acquired for the purpose of a trade"" The distinction between capital accretions and profits of adventure in trade has been well stated in the case of *California Copper Syndicate v. Harris.* 5 TC 159.

"It is quite well settled principle in dealing with questions of assessment of income tax that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit assessable to income tax. But it is equally well established that enhanced values obtained from realization or conversion of securities may be so assessable where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being is the sum of gain that has been made a mere enhancement of value by realizing a security or is it a gain made in an operation of business in carrying out a scheme for profit making." – Lord Justice Clerk.

2. The Basis of Liability to Capital Gains

Every person is liable to capital gains tax on the capital gains arising in the year of assessment. Persons resident in Sri Lanka are chargeable on the capital gains wherever arising and a non-resident person is chargeable on the capital gains arising in Sri Lanka. Capital loss can only be set off against capital gains. Any excess of capital loss over capital gain can be carried forward and set off against capital gains of future years of assessment. S. 29(6)(a)(ii).

Any unabsorbed capital loss in the last year of assessment of an individual at death and in respect of a company in liquidation can be set off against the statutory income of the last year of assessment and if such capital loss cannot be fully set off can be set off in the order of recession against the statutory income of any of the three years preceeding the last year of assessment: S. 29(6)(d).

The basis of computing capital gains and capital losses are to be made in the prescribed manner. In computing capital gains or capital loss only expenses which are permitted can be deducted. S. 7(4).

3. **The Scope of Capital Gains**

Capital gains arise in the following manner and is chargeable with Capital gains tax:

(a) on the charge of ownership of property; S. 7(1)(a).
(b) on the surrender or reliquishment of any rights in any property; S. 7(1)(b).
(c) on the transfer of some rights in any property: S. 7(1)(c);
(d) on the redemption of shares, debentures or other obligations; S. 7(1)(d);
(e) on the formation of a company: S. 7(1)(e);
(f) on the amalgamation or merger of two or more businesses or companies: S. 7(1)(g);
(h) on receipt of any commission or reward for promoting any transaction without being a party to such transaction: S. 7(1)(h);
(i) on the change of ownership of jewellery: S. 14(a)(x);

Capital Gains arising in the following manner are not chargeable with Capital Gains tax:

(a) on the sale by any individual of any house constructed by him and used solely for residential purposes, such sale being the first sale of that house: S. 14(a)(i);
(b) on the sale of any house owned by any individual and used solely for residential purposes if such individual hsa not sold any house other than a house referred in paragraph (a) above on or after April 1, 1978. 14(a) (ii). The Commissioner General of Inland Revenue has given a ruling that "in the application of this section relief will be granted to a Co-owner of a house who sells his share in the house. The Co-owner, however, will not be entitled to relief from capital gains on any subsequent sale of a house or a share of house. It should be ensured that the saie of the share of the house on which relief being claimed is the first sale of a house or a share ot a house made on or after April 01, 1978, other than a house referred to in section 14(a)(i)"
(c) on the sale of any property held primarily for sale to customers in the ordinary course of trade: S. 14(a)(iii);
(d) on the sale of any property which was used by any person for producing income in any trade, business, profession or vocation on which depreciation has been allowed: S. 14(a)(iv);

(e) on the passing of any property subject to a trust from the trustee to any beneficiary under the trust: S. 14(a)(v);

(f) on the passing of any property from the executor of the estate of a deceased person to any testate or intestate heirs: S. 14(a)(vi);

(g) on the passing of any property to any person on the death of the owner of that property. S. 14(a)(vii);

(h) on the passing of any property by gift of that property, by its owner to any other person: S. 14(a)(viii);

(i) on the passing of any shares in any company in Sri Lanka with which an agreement has been entered into by the Greater Colombo Economic Commission from the owner to any other person by sale, gift or otherwise: S. 14(a)(ix);

(j) on the change of ownership of any motor vehicle on which no depreciation has been allowed: S. 14(a)(x);

(k) on the change of ownership of any household effects or any articles of personal use other than jewellery: S. 14(a)(x);

(l) on the change of ownership by transfer of a right to exploit a property: S. 14(a)(xi);

(m) on the surrender of a life insurance policy and the surrender, transfer or extinction of a life interest: S. 14(a)(xii);

(n) on the disposal of any shares in a quoted public company: S. 14 (a)(xiii);[1]

(o) on the transfer of assets of an individual or a partnership upon conversion of such business carried on by them into a quoted public company provided that such assets are valued at a price not exceeding the market value of those assets as at March 31, 1977; S. 14(a)(xiv);[1]

(p) where the aggregate amount of the capital gains arising to any person for an year of assessment in respect of movable property other than stock, shares, debentures or debenture stocks. if such aggregate amount does not exceed Rs. 2,000: S. 14(b);

(q) the first Rs. 5,000 of the capital gains of any year of assessment of any person is not chargeable with tax if his total assessable income for the three years immediately preceeding that year of assessment is less than the total tax free allowances he would have been entitled to for those three years: S. 14(c). see para 21.

In addition to the above, any gains which are treated as profits or income under other sources of income will not be chargeable as capital gains.

4. Computation of Capital Gains or Capital Losses

Capital gain or a capital loss is realised on the change of ownership of assets chargeable with capital gains tax. In computing capital gains or loss the law provides for the deduction of certain allowable costs and expenditure: S. 7(4);

1. 24 of 1980.

The following elements will figure in computing capital gains or capital losses:

(a) value of acquisition;
(b) value of property at the time of change of ownership;
(c) value of consideration received;
(d) market value;
(e) allowable expenditure.

(a) **Value of acquisition**

There are four basis for ascertaining the cost of acquisition:

(i) where the property was acquired before April 01, 1957, the cost of acquisition is the market value of that property as at April 01, 1957;

(ii) where the property acquired after April 01, 1957 is by purchase the cost of acquisition is the cost of purchase. All costs in addition to purchase price incurred in the acquistion will be the cost of purchase of the property.

(iii) where the property was acquired otherwise than by purchase, for example by gift or otherwise, after April 01, 1957, the cost of acquisition is the market value of that property at the time of such acquisition.

(iv) the value of acquisition to the person who acquires an immovable property after April 01, 1977 by gift or inheritance from a person who owned that property prior to April 01, 1977, is the market value of that property on April 01, 1977, increased by the cost of improvements, additions or alterations made by him to that property after April 01, 1977. S. 7(3)(l).[1]

(b) **Value of property at the time of change of ownership**

There are two basis of ascertaining the value of property at the time of change of ownership:

(i) where there has been a sale, the value at the time of the occurence of the transaction is the sale price;

(ii) where the transaction is otherwise than by sale, the value of the property at the time of the occurence of transaction is its market value at that time.

Where the Assessor is of opinion that the sale price is less than the market value of that property at the time of the sale, and no satisfactory explanation for the difference in the price has been given by the taxpayer, the market value will be regarded as the sale price of that property at that time. S. 7(3)(k);

(c) **Value of consideration received**

The value of consideration received by the person to whom capital gains arises is determined as follows:

(i) where the consideration is partly cash and partly property other than cash, the aggregate of cash and the market value of the property on the date of receipt.

---

1. 24 of 1980.

(ii) where the consideration received is wholly property, the market value will be taken into account. S. 7(3)(j).

(d) **Market value**

Valuation on the basis of market value is adopted in the following cases:

(i) tc ascertain the value of property acquired before 1st April, 1957;

(ii) to ascertain the value of the property acquired otherwise than by purchse;

(iii) to ascertain the value at the time of the occurence of the transaction where such transaction is other than a sale;

(iv) where the Assessor is of opinion that the sale price is less than the market value of that property at the time of the sale: S. 7(3)(k).

Market value of any property is defined as the price which that property would have fetched on that date in an open market; S. 163; An open market sale would generally mean a sale between a willing seller and a willing buyer bargaining on equal terms and at terms length, so that the price received or given reflects a fair and true price for the assets. It is the best price obtainable for the vendor taking into account all the circumstances and conditions prevailing at that time.

(e) **Expenditure deductable in computing Capital Gains.** S. 7(4).

Following deductions are permitted in computing capital gains or capital losses.

(i) Expenditure incurred solely in connection with acquisition of property after April 01, 1957;

(ii) Expenditure in making any improvements additions or alteration after April 01, 1957;

(iii) Expenditure solely connected with the transaction which result in Capital Gains or Losses,

(iv) Special deduction from Capital Gains.

(i) **Expenditure solely in connection with the acquisition**

Expenditure incurred solely in connection with the acquisition of the property after April 01, 1957 is a permitted deduction in computing capital gain or loss. Following expenditure which are connected with the acquisition of property can be claimed:

(a) cost of advertising in connection with the purchase:

(b) cost of professional services of any Surveyor, Valuer, Broker or Legal Advisor;

(c) stamp duty and lawyers fees connected with the acquisition;

(d) expenses connected with registration of shares.

It would appear that expenses connected with the raising of a loan for the purchase of the property and the interest subsequently paid on such loans may be claimed as these would rightly be cost of acquisition or expenses solely in connection with the acquisition, provided the loan was utilised for the purchase of that property.

Estate Duty paid was considered deductible in computing capital gains in the case of *H. A. Peiris v. C.G.I.R.* S/C 3/75.

"The sub-section does not contemplate only the expenditure immediately connected with the transaction, such as auctioneers' or brokers' fees. The meaning appears to be wider than that. The death duty that is payable on a property is the first charge on the property and attaches to that property whosoever may become the owner of that property. No person aware of this charge will offer a price without taking the duty due into consideration. It is not different to a mortgage on the property. If then a person who acquires a property has to pay death duty due on it, it is expenditure incurred in connection with the acquisition." – Wijesundera J.

Expenses incurred by the executor in obtaining probate in respect of which legal costs were incurred were considered deductible in computing capital gains in the case of *C.I.R. v. Richards Executors* (1971) 1 W.L.R. 571. Lord President observed that the whole of the steps taken to obtain probate in respect of which legal costs were incurred is in itself a compulsory preliminary stage in the single operation of estalishing the right of the executors to deal with the estate.

(ii) **Expenditure in making any improvements, additions or alterations.** S. 7(4)(b).[1]

Expenditure incurred after April 01, 1957 in respect of expenditure by the owner in making any improvements, additions or alterations to the property can be deducted in computing the capital gains or loss. Improvements, additions or alterations generally enchance the value of the property and are therefore specifically allowed as deductions, in computing capital gain or loss. However, the expenditure in making improvements, additions or alterations are capital in nature and where such expenditure has been specifically allowed in computing the profits for tax purposes of any trade, business, profession or vocation carried on by any person, then deduction of such expenditure will not be permitted in computing capital gains or loss.

The expenditure on improvements, additions or alterations which are not permitted to be deducted in computing capital gains or loss are;

(a) Expenditure allowed under section 23.
(b) Expenditure allowed under section 31(1).[1]

The expenditure allowed under section 23 refers to expenditure in improvements, additions or alterations which in terms of this provision are deductible in computing profits for tax purposes Such expenditure will cover;

(a) renewals.
(b) depreciation allowance in respect of improvements or additions.
(c) in respect of agricultural land and livestock farming, fishing etc.
    (a) Expenditure on opening up of land;
    (b) construction of roads and tracks;
    (c) construction of wells, tanks, irrigation channels;
    (d) initial planting material, livestock;
    (e) replanting and maintenance of immature areas.

1. 24 of 1980.

The expenditure allowed under section 31(1)[1] refer to expenditure in constructing any house or flat for the occupation as a dwelling house for an employee. Such expenditure is allowed as a qualifying payment in computing the liability to tax. Thus when a sale of such house or flat is made, the expenditure allowed as qualifying payment cannot be deducted in computing the capital gains.

Expenditure on repairs are not improvements and cannot therefore be deducted in computing capital gain or loss.

(iii) **Expenditure solely connected with the transaction which result in capital gain or loss**

The following expenditure may be claimed:-

(a) expenditure on advertising connected with the sale;

(b) expenditure on professional services of surveyor, valuer, broker of legal adviser;

(c) expenditure in establishing and preserving or defending title;

(d) other incidental costs connected with the sale.

(iv) **Special deductions from Capital Gains.** S. 7(4)(d).

Where capital gains arise on change of ownership of any property held by the owner for a period not less than five years a special deduction is allowed from the capital gains computed in accordance with the provision of the Act. The deductions permitted vary with the length of ownership and is made as follows:-

(a) 25% of the capital gains where the change of ownership occurs not less than five years, but not more than fifteen years after the acquisition of that property;

(b) 50% of the capital gains where the change of ownership occurs over fifteen years after the acquisition of that property.

5. Computation of Capital Gain/Loss on particular Assets or Transactions

The method of computation of capital gain or loss is laid down in the law. Generally, the amount of the capital gain or loss is computed by taking the consideration received on the change of ownership of the asset and deducting therefrom the cost of the asset and expenditure solely related to the acquisition and disposal of the asset.

Change of Ownership

A change of ownership occurs in every conceivable manner by:

(a) sale;

(b) disposal;

(c) transfer;

(d) realisation;

(e) exchange; or

(f) in any other manner.

---

1. 24 of 1980

Transfer of property means any disposition, conveyance, assignment, settlement, delivery, payment or other alienation of property including the creation of trust in property and the grant or creation of any interest in any property. S. 163.

6. Computation of Capital Gain or Loss on change of ownership of property

Specific rules of computation have been laid down in computing capital gains or capital losses. These are discussed under the following headings:-

(a) Movable and Immovable Property acquired otherwise than by gift or inheritance;

(b) Property acquired by a beneficiary or heir from a trustee or Executor or Administrator of the estate of a deceased person. S. 7(3)(c).

(c) Immovable Property acquired by gift or inheritance. S. 7(3)(l).

(d) Property coming into possession immediately after cessation of life interest or cessation of the rights of a fiduciary in that property. S. 7(3)(d).

(e) Shares in Companies

- (i) shares which include bonus shares. S. 7(3)(e).
- (ii) shares received on amalgamation or merger of two or more companies. S. 7(3)(g).
- (iii) shares in respect of which there have been a return or distribution of capital. S. 7(3)(h).
- (iv) shares issued at a price which is less than market value. S. 7(3)(f).

7. Movable and Immovable Property acquired otherwise than by gift or inheritance

Capital gain on the change of ownership of property is the excess of the value of the property at the time when such change of ownership occurs over the value of that property at the time when it was acquired taking into account expenditure which are deductible in computing the capital gains. In computing capital gains only permitted deduction in respect of expenditure are allowed including a special deduction in respect of property owned for over five years from the date of acquisition.

Capital loss is the amount by which the value of that property at the time of the change of ownership occurs is less than its value at the time when it was acquired by that person taking into account expenditure which are permitted to be deducted in computing such loss. S. 29(6)(b)(i).

Example:

Transaction of Mr. Perera during year ended 31.3.1983 are:

(1) House property in Kollupitiya, purchased by him in 1950 for Rs. 100,000 was sold by him for Rs. 150,000. He incurred the following expenditure:

(i)	additional room and garage built in 1961 ...	Rs. 10,000
(ii)	Building of boundary walls	5,000
(iii)	Advertisement for sale of property	105
(iv)	Brokers fees	3,000
(v)	Valuation fees	500

The value of the property as at 31.3.1957 was agreed with the Assessor at Rs. 125,000.

(2) Land at Ratmalana, purchased by him in 1960 for Rs. 50,000. He sold the property on 30,8.1982 for Rs. 50,000. He incurred the following expenditure in the purchase and the sale of this property:

(i)	Stamp duty on the purchase	Rs. 1,500
(ii)	Lawyers fees	500
(iii)	Advertisement for sale	100
(iv)	Brokers fees	500
(v)	Levelling and filling of land	1,500

Computaion	Rs.	Rs.	Rs.
(1) House at Kollupitiya			
Sale Price			150,000
Less: Cost of acquisition ...		125,000	
Expenditure on improvements			
Extension	10,000		
Boundary wall	5,000	15,000	
Expenses of sale:			
Advertising	150		
Brokers fees	3,000		
Valuation fee	500	3,650	143,650
Capital gain			6,350
Less: Special deduction 50%			3,175
Capital gain			3,175

	Rs.	Rs.	Rs.
(2) Ratmalana property			
sale price			50,000
Less: cost of acquistion ...		50,000	
Expenditure on acquisition– ...			
Stamp duty	1,500		
Lawyers fees ...	500	2,000	
Improvements on the land ...		1,500	
Expenditure on the sale– ...			
Advertising	100		
Brokers fees	500	600	54,100
Capital loss			4,100

Capital gains/loss for the year of Assessment 1982/83:

Capital gains on Kollupitiya property	Rs. 3,175
Capital loss on Ratmalana property	4,100
Capital loss carried forward	925

8. **Property acquired by a beneficiary from a Trustee or Executor or Administrator**: S. 7(3)(c)

Where in respect of a property which has passed to a beneficiary under a trust or to the testate or intestate heir of the estate of a deceased person, the value of acquisition for the purpose of computing capital gain or loss on disposal of that property by the beneficiary or heir will be determined as follows:

(i) where the property was acquired by the Trustee or Executor before April 01, 1957, the value of acquisition will be the market value of that property on April 01, 1957;

(ii) where the property was acquired by the Trustee or Executor after April 01, 1957, the value of acquisition will be the market value of that property on the date of acquisition by such Trustee or Executor.

(iii) where immovable property is acquired after April 01, 1957 by way of inheritance, that is, when the property passes on to a testate or intestate heir of the estate of a deceased person who owned it prior to April 01, 1977, the value at acquisition to the heir will be the market value on April 01, 1977 increased by the cost of improvements, additions or alterations, to that property made by the deceased after April 01, S. 7(3)(I).[1]

A Trustee or an Executor is not chargeable with capital gains tax on capital gains arising on the passing of property from such trustee or executor to a beneficiary or heir. S. 14(a)(v) & (vi). There is also no liability on capital gains arising on the passing of property to any person on the death of the owner of that property. S. 14(a)(vii). The beneficial owners, that is the beneficiaries or heirs are chargeable with capital gains arising on the disposal by them of property acquired by them as beneficiares or heirs.

Example:

Mr. Perera created a trust of a property valued Rs. 100,000 in favour of his minor son, Sunil, on 1st April, 1960. The property passed to Sunil on 10th October, 1976, on his attaining majority. The value of the property on 10th October, 1976 was Rs. 125,000. Sunil sold the property on 1st July, 1982 for Rs. 150,000.

				Rs.
Sale price	...	...	...	...	150,000
Cost of acquisition	...	...	...	100,000
Capital gain	...	...	...	50,000
Less: Special deduction — 50%		...	...	25,000
Capital gains	...	...	...	25,000

9. Property coming into possession immediately after cessation of life interest or the cessation of the rights of a fiduciary. S. 7(3)(e)

In the case of property which comes into possession of the owner, on the cessation of life interest of any other person or after the cessation of the rights of any fiduciary in that property the value of acquisition for the purpose of computing Capital gains or loss is:

(i) if the date of cessation of life interest of such rights of a fiduciary is before 1st April 1957, the value of acquisition is the market value of the property as at 1st April 1957;

---

1. 24 of 1980.

(ii) if the date of cessation of such life interest or such rights of a fiduciary is on or after 1st April 1957 the value of acquisition will be the market value of the property on such date.

Example:

Mr. Perera transferred his residential house to his daughter Shanti on 1st April 1969, reserving life interest on the property. The value of the property on this date was Rs. 125,000. Mr. Perera died on 1st January 1975 and the value of the property on that date was Rs. 100,000. Shanti sold the property for Rs. 175,000 on 31st March 1982.

	Rs.
Sale price	175,000
Less: Value of acquisition	100,000
Capital gain	75,000
Special deduction — 25%	18,750
Capital gain	56,250

10. **Immovable property acquired by gift or inheritance after April 01, 1977**: S. 7(3)(l).[1]

In computing the capital gain or loss in respect of immovable property acquired by gift or inheritance after April 01, 1977 from a person who owned it prior to April 01, 1977, the value of acquisition shall be the market value of that property on April 01, 1977 increased by the cost of any improvements, additions or alterations to that property made by the donor or the deceased person as the case may be.

Example:

Mr. Perera gifted his estate to his daughter Shanti Perera on January 01, 1979 valued at Rs. 200,000 as at that date. This property was inherited by him in 1950 and the market value of this property as at April 01, 1977 was Rs. 150,000. Mr. Perera built a bungalow on the estate during 1978 costing Rs. 75,000. Shanti Perera made further improvements to the bungalow by adding two additional bed rooms costing Rs. 100,000 during 1980. She sold the estate on October 17, 1982 for Rs. 400,000. She did not incur any expenditure on the acqusition or on the sale.

Computation of Capital Gains

Sale Price		Rs. 400,000
Less: Cost of Acquisition:-		
Market value 01.04.1957	Rs. 150,000	
Improvements – Mr. Perera ...	225,000	
Improvements – Shanti Perera ...	100,000	325,000
Capital Gain		Rs. 75,000

11. **Where the shareholding is bonus shares**: S. 7(3)(e);

Where the property is a bonus share issued on or after April 01, 1957, the value for the purpose of the computation of capital gains is deemed to be NIL.

1. 24 of 1980

Example:

The shareholdings of Mr. X in a company Y Ltd. is as follows:

(i) 100 shares of Rs. 10 each purchased at par in 1950. The market value of these shares is Rs. 6 as at 01.04.1957;

(ii) 100 shares of Rs. 10 received as bonus shares in 1960.

The entirety of the shareholding were sold by Mr. X on 01.10.1982 for Rs. 2,000.

Computation of Capital Gains

Cost of acquisition:

100 shares 1950 – Market value as at 01.04.1957	Rs.	600
100 Bonus shares	...	NIL
	Rs.	600
Sale price	Rs.	2,000
Capital gains	Rs.	1,400
Less: special deduction on – 50% ...	Rs.	700
Capital gain	Rs.	700

12. **Shares issued at a price less than the market value of such shares.** S. 7(3)(f).

The value of acquisition of shares which were acquired at a price less than the market value of such shares is equal to the cost of acquisition of those shares.

Example:

Mr. X acquired 100 shares in XY Ltd. on 01.10.1975 at Rs. 5. The market value of these shares as at 01.10.1975 was Rs. 10. The shares were sold at Rs. 4 – of 10th October 1982.

Computation of Capital Loss:

Sale price 100 × Rs. 4	Rs.	400
Value of acquisition 100 × 5	Rs.	500
Capital Loss	Rs.	100

13. **Where the shareholdings include shares received on the amalgamation or merger of two or more companies:** S. 7(3)(g).

Where a person's shareholdings include shares received on the amal gamation or merger of two or more companies, the cost of acquisition of the original holdings for the purpose of computation of capital gain or loss is;

(i) if the shares were acquired before 1st April, 1957, the value of acquisition is the market value of the shares as at 1st April 1957;

(ii) if the shares were acquired after 1st April 1957 by purchase be an amount equal to the cost of purchase and if acquired by him otherwise than by purchase, the market value at the date of acquisition.

Example:

Mr. Perera bought 100 shares of Rs. 10 each in X Ltd., for Rs. 1,000 on 1st August 1969. The company amalgamated with another company Y Ltd. forming a new company XY Ltd., and Mr. Perera received 200 shares of Rs. 10 each in the new company in exchange for his shares in X Ltd. He sold his entire holdings on 1st February 1982 for Rs. 2,500.

Sale Price	Rs.	2,500
Cost of acqusition	Rs.	1,000
Capital Gain	Rs.	1,500
Less: Special deduction – 25%	Rs.	375
Capital Gain	Rs.	1,125

14. **Where the shareholdings include shares in respect of which there has been a return or distribution of capital.** S. 7(3)(h);

Where a person's holdings include shares on which there has been a return or distribution of capital the value of acquisition, for the purpose of computation of capital gain or loss:

(i) if the shares were acquired before 1st April, 1957, the value of acquisition is the market value of the shares as at 1st April, 1957 less the amount of the capital returned or distributed after 1st April, 1957.

(ii) if the shares were acquired after 1st April, 1957, the value of acquisition is equal to the cost of purchase or the market value if acquired otherwise than by purchase less the amount of capital returned or distributed after that date.

Where the capital returned or distributed is deemed to be dividend under other provisions of the Inland Revenue Act, then adjustments to the value of the shares in respect of the return or distribution will be made.

Example:

Mr. Perera purchased 1000 shares of Rs. 10 each in XYZ Ltd., in 1960 at par. The company reduced its capital and returned to its shareholders Rs. 5 of the share capital on each share in 1975. Mr. Perera sold his entire shareholdings on 1st January, 1980, at Rs. 8 each.

Sale price: 8 × 1,000			Rs.	8,000
Value of acquisition	Rs.	10,000		
Less: Capital returned 1,000 × 5 ...	Rs.	5,000		5,000
Capital gain			Rs.	3,000
Less: Special deduction – 50%			Rs.	1,500
Capital gain			Rs.	1,500

15. **Surrender or Relinquishment of any right in any property or the transfer of some of the right in any property**: S. 7(2)(b).

Rights contain an immediate economic or monetary value in the sense that they are capable of being measured directly in terms of money or its equivalent. Examples of rights are: personal servitudes over immovable property, grant of rights in respect of minerals, lease of immovable property, charges on land, grant of right of way, right to receive annuity, etc.

The amount of the capital gains is the consideration received less any expenses incurred in connection with the transfer or the relinquishment of such rights.

Example 1:

Mr. Perera sold to Mr. Silva the right of passage over his land, the consideration being the payment of Rs. 5,000. Expenses connected with the agreement amounted to Rs. 1,000.

Consideration received	...	...	... Rs. 5,000
Expenses ...	...	...	... Rs. 1,000
Capital gain	...	...	... Rs. 4,000

Example 2:

Mr. Perera in order to provide for the educational expenses of his brother, Sunil, gave to his brother the right to receive the rent of a house property at Kollupitiya, the annual rent of which is Rs. 10,000 per annum, for 15 years from 1965.

Sunil agreed with his brother to surrender his rights to receive the rent from this property on payment of Rs. 25,000 so as to enable him to sell this property. Sunil accepted the offer and surrendered his right to receive the rent. The expenses of the lawyers fee and the stamp duty Rs. 3,000 was paid by Sunil.

Computation of Capital Gains

Consideration received	...	...	... Rs. 25,000
Expenses ...	...	...	... Rs. 3,000
Capital gain	...	...	... Rs. 22,000

16. Redemption of shares, debentures and other obligations:
S. 7(2)(c);

When shareholders or debenture-holders receive property on redemption capital gain or loss may arise. Capital gain or loss is computed by deducting from the consideration received the value of acquisition and expenses connected with the transaction.

The value of acquisition for the purpose of the computation of capital gain or loss is:

(a) if acquired before 1st April, 1957, be its market value at 1st April, 1957;

(b) if acquired after 1st April, 1957 the cost to him at the time of acquisition.

The value of acquisition in respect of shares may have to be adjusted where shares include:

(a) bonus shares;

(b) shares issued at a price less than its market value;

(c) shares consist of shares received on the amalgamation or merger of two or more companies;

(d) shares consist of shares on which there have been a return or distribution of capital.

Example:

Mr. Perera purchased 100 Redeemable preference shares of Rs. 10 each in XYZ Ltd., at Rs. 8.50 per share in 1970. The shares were redeemed at par on 1st January 1982.

Value of consideration received	...	...	Rs.	1,000
Value of acquisition ...	...	...	Rs.	850
Capital gain ...	...	...	Rs.	150
Less: Special deduction – 25%	...	...	Rs.	37
Capital gain ...	...	...	Rs.	113

17. **Formation of a Company.** S. 7(2)(d)

Person responsible for the formation of the company is the company promoter. Any profits accruing to him as a result of the formation of the company is treated as capital gain.

The amount of the capital gain is the value of the consideration received less expenses connected with the transaction.

18. **Dissolution of a Business**: S. 7(2)(e).

When a business is dissolved capital gain or loss may arise. Capital gain or loss is computed by deducting from the value of all property received in consequence of dissolution, the value of the share capital at the time the business was acquired and the expenses connected with the dissolution.

Value of acquisition of a business:

The value of the share capital at acquisition may vary with any withdrawal of capital or fresh introductions of capital and must therefore be adjusted. The value of acquisition is the value of the original share capital plus fresh capital introduced less any share capital withdrawn.

If the business has been in existence on 1st April, 1957, the value of all the assets of the company at the market value at 1st April, 1957, is taken to ascertain the value of acquisition of the share capital on that date.

Value of all property received.

All the assets of the company must be separately considered. The value of all the property received is the value realised plus cash in hand less the liabilities of the business and the profits retained in the business.

Partnership

In the case of a dissolution of a partnership any disposal of the assets of the partnership may result in capital gain or loss and such capital gain or loss may be apportioned among partners.

Since an interest of a partner in a partnership is the right of a partner to share the profits and obtain his share of the capital, any amount paid to him on dissolution or retirement may not amount to a change of ownership or transfer of his share and therefore capital gains liability may not arise.

Example of dissolution of business:

Mr. Perera commenced business as a grocer on 10.04.1975. The balance sheet of the business on that date is as follows:

		Rs.			Rs.
Capital	...	50,000	Land & buildings	...	50,000
Creditors	...	27,000	Furniture & fittings	...	5,000
			Stocks ...	...	20,000
			Cash at bank & in hand		2,000
		77,000			77,000

He sold his business to Mr. Silva on 01.04.1982 for Rs. 75,000. The Balance Sheet of the business as at 01.04.1982 is as follows:

		Rs.			Rs.
Capital	...	50,000	Land & buildings	...	50,000
Profit & Loss	...	5,000	Furniture & fittings	...	4,000
Creditors	...	26,500	Debtors	...	10,000
			Stocks ...	...	15,000
			Cash in hand & at Bank		2,500
		81,500			81,500

It was agreed that Mr. Perera takes over the debtors at book value and that he will pay off the creditors in full. Stock and the furniture and fittings was also taken over at book value by Mr. Silva. The land and buildings were valued by a reputed valuer at Rs. 50,000.

		Rs.	Rs.
Sale proceeds	... ...		75,000
Add: Debtors taken over	... ...	10,000	
Cash	... ...	2,500	12,500
			87,500
Less: Creditors paid off	... ...	26,500	
Profits and Loss account	... ...	5,000	31,500
Value of property received	... ...		56,000
Less: Value of acquisition	... ...		50,000
Capital gain	... ...		6,000
Less: Special deduction – 25%	... ...		1,500
Capital gain	... ...		4,500

19. Liquidation of a Company. S. 7(2)(e):

On the liquidation of a company shareholders are entitled to receive their share capital back, which may result in a capital gain or loss. Capital gain or loss arise on receipt of property in consequence of liquidation and the receipt of property may be at different times depending on the manner the Liquidator distributes property to the shareholders. It will therefore be necessary to compute capital gain or loss as and when the shareholder receives property on liquidation.

Capital gain or loss is arrived at by deducting from the value of all property received the value of the shares when such shares were acquired plus the expenses in connection with the transaction.

The value of the shares at the time they were acquired will be:-

(a) if the shares were acquired before 1st April, 1957, the market value of those shares as on that date;

(b) if the shares were acquired after 1st April, 1957, the cost price of the shares.

The value of the shares at the time of acquisition will have to be adjusted if:-

(a) the shares consist of bonus shares;

(b) shares consists of shares issued at a price less than its market value;

(c) shares on which there has been a distribution or return of capital.

(d) shares consist of shares received on amalgamation or merger of two or more companies.

Example:

Mr. Perera bought 1,000 shares of Rs. 10 each in XYZ Ltd., on 01.02.1977 for Rs. 9 each. The company went into voluntary liquidation on 31.12.1979 and the liquidator made the following distributions:

on 01.01.1980 – Rs. 5 on each share
on 01.01.1981 – Rs. 5 on each share
on 03.03.1982 – Rs. 4 on each share

Mr. Perera did not have any other transactions which gave rise to capital gain or loss.

Year of Assessment 1979/80

Value of property received	Rs.	5,000
Value of acquisition	Rs.	9,000
Capital loss	Rs.	4,000
Capital loss carried forward for the year 1980/81 ...	Rs.	4,000

Year of Assessment 1980/81

Value of consideration received	Rs.	5,000
Value of acquisition	Rs.	NIL
		5,000
Less: Capital Loss brought forward from 1980/81 ...	Rs.	4,000
Capital gain	Rs.	1,000

Year of Assessment 1981/82

Value of consideration received	Rs.	4,000
Value of acquisition		NIL
Capital gain	Rs.	4,000
Less: Special decution 25%	Rs.	1,000
Capital gain	Rs.	3,000

Liability of the Company

The company may in itself make a capital gain or capital loss on liquidation on the disposal of its assets. Such capital gain or loss of the company does not have relationship to the capital gain or loss of the shareholders and such liability is determined separately.

Where a company is liquidated and has any capital loss for the last year of assessment for which it is liable to be assessed, the amount of such capital loss shall be deducted from that last year of assessment and any unabsorbed capital loss shall be deducted from any of the three years of assessment immediately preceeding, the last year of assessment. S. 29(d)(iii).[1] Any tax paid in excess arising out of this revision of assessment will be repaid to the company.

20. **Amalgamation or merger of two or more Companies:** S. 7(2)(f):

Amalgamation or merger of two or more companies takes place when control over another company is considered desirable.

When two or more companies amalgamate or merge, the shareholders are allotted shares in the new company in exchange for the old shares. No capital gains will arise on the companies merging or amalgamating.

Capital gains will arise when the shareholder receives any money in consequence of the amalgamation or merger and the entire value received is capital gains.

Where the person receiving any consideration is not the shareholder of any of these Companies, the value of consideration received by him in connection with the amalgamation or merger will be regarded as capital gain.

The meaning of the word amalgamation as per Buckley J. is:

"An amalgamation involves ...... the rolling, somehow or other, of two concerns into one. You must weld two things together and arrive at an amalgamation – a blending of two undertakings. It does not necessarily follow that the whole of the two undertakings should pass – substantially they would pass – nor need all the corporators be parties. The difference between reconstruction and amalgamation is that in the latter is involved the blending of two concerns, one with the other, and not merely the continuance of one concern ...... It is not necessary that you should have a new company. You may have a continuance of one of the two companies upon the terms that the undertakings of both corporations shall substantially be merged into one corporation only." – *South African Supply and Cold Storage Co. Ltd.*, (1904) 2 ch. 268.

21. **Promotion of a transaction without being a party to such transaction:** S. 7(2)(g):

Any person receiving any sum for promoting any transaction without being a party to such transaction, such sum received as commission or reward is capital gains

---

1. 40 of 1981.

22. **Exemption of capital gains up to Rs. 5,000:** S. 14(c):

This exemption will apply to any person who has a total assessable income for the three years of assessment immediately preceeding that year of assessment which is less than the total tax free deductions that the assessee would have been entitled to claim for those three years of assessment.

Example:

Mr. Perera's profits from his employment were as follows:

Year ended 31.03.1980	...	Rs. 10,000
Year ended 31.03.1981	...	Rs. 11,000
Year ended 31.03.1982	...	Rs. 12,000

He has no other sources of income. He is married, and his family consists of his wife and four children. His housing loan repayment for each of three year is Rs. 2,000.

He sold his residential house for Rs. 100,000 on 1st June 1982 which was purchased by him in 1970 for Rs. 75,000.

Computation of capital gains – Year of Assessment 1982/83:

	Sale proceeds	... ...	Rs.	100,000
	Value of acquisition	... ...	Rs.	75,000
	Capital gain	... ...	Rs.	25,000
Less:	Special deduction 25%	... ...	Rs.	6,250
	Capital gain	... ...	Rs.	18,750
Less:	Exemption	... ...	Rs.	5,000
	Capital gain assessable	... ...	Rs.	13,750

Mr. Perera's assessable income and allowance he was entitled to deduct is given below. The total assessable income is less than the total tax free allowance to which Mr. Perera was entitled to for these three years.

	1979/80	*1980/81*	*1981/82*	*Total*
Assessable Income ...	10,000	11,000	12,000	33,000
Allowances he is entitled to:				
Personal allowance ...	12,000	12,000	12,000	36,000
Qualifying payment ...	2,000	2,000	2,000	6,000
Rs.	14,000	14,000	14,000	42,000

23. **Calculation of Capital Gains Tax. 32(3):**

Capital gains is a source of income on which the maximum rate of income tax payable does not exceed 25%. Where the taxable income of an individual, which includes net capital gains, and the rate of tax applicable on such taxable income exceeds 25% the tax payable is calculated as follows:

(a) where the portion of the taxable income falls to be taxed at rates exceeding 25% then the amount of the net capital gains is taxed at 25%; and

(b) the balance of the taxable income is taxed at the appropriate rate or rates of tax.

Small Company

The maximum rate of tax at which a small company is liable on Capital Gains is 25%. Since the rate of tax to which a small company is liable vary from 20% to 50% adjustment to the calculation of tax is made whereby the rate applicable to Capital Gains is restricted to 25%.

Where the part of the taxable income of a small company includes capital gains and the rate of income tax payable on a part of such income exceed 25%, then tax payable is computed as follows: S. 33 1B(b).[1]

(a) Where a part of the taxable income which include capital gains exceed the amount of the capital gains the tax payable on the capital gain is restricted to 25% and the balance income is taxed at rates exceeding 25% applicable to such a small company;

(b) Where that part of the taxable income including capital gains does not exceed the amount of the capital gains, then the entirety of that part of the taxable income is taxed at 25%.

Please see Example of computing capital gain tax in para 25 of Chapter 6.

Example I

Mr. Perera's income from profession for year ended 31.03.1982 was Rs. 45,200. The net capital gains for this year was Rs. 10,000.

Profession	... ...	... Rs. 45,200
Net capital gain	...	... Rs. 10,000
Assessable income	...	... Rs. 55,200
Tax free allowances	...	... Rs. 12 000
Taxable income	...	... Rs. 43.200

Taxed as follows:

		Rs.
4,800 at 7½%	...	... 360
4,800 at 10%	...	... 480
4,800 at 15%	...	... 720
4,800 at 20%	...	... 960
4,800 at 25%	...	... 1,200
4,800 at 30%	...	... 1,440
4,400 at 35%	...	... 1,540
10.000 at 25%	...	... 2,500
		9,200

Example II

Mr. Perera's income from profession for the year ended 31.03.1982 was Rs. 21,800. His net capital gains for this period was Rs. 7,800.

His income tax payable is calculated as follows:

	Profession		... Rs. 21,800
	Capital gains	...	... Rs. 7,800
	Assessable income	...	... Rs. 29,600
Less:	Tax free allowance	...	... Rs. 12,000
	Taxable income	...	... Rs. 17,600

1 40 of 1981

Taxed as follows:

			Rs.
4,800 at $7\frac{1}{2}\%$	...	...	360
4,800 at 10%	...	...	480
4,800 at 15%	...	...	720
3,200 at 20%	...	...	640
Tax payable	...	...	2,200

24. Capital Loss

Capital loss may arise on:–

(a) the change of ownership of any property. S. 29(6)(b)(i);

(b) on the redemption of any shares, debentures or other obligations. S. 29(6)(b)(ii);

(c) on the liquidation of a company. S. 26(6)(b)(iii);

(d) on the dissolution of a business. S. 29(6)(b)(iii);

(e) any debt which is not a trade debt which is proved to be due on documentary evidence and proved to be irrecoverable: S. 29 (6)(b)(iv).[1]

Computation of Capital Loss:

Computation of capital loss is approached in the same way as the computation of capital gains. In computing capital loss following deductions are permitted: S. 29(6)(c);

(a) expenditure connected with the acquisition of the property;

(b) expenditure in making any improvements or additions;

(c) expenditure solely connected with the transaction which resulted in the loss.

Set off of Capital Loss: S. 29(6);

A capital loss can only be set off or deducted from capital gain. Any capital loss which cannot be set off against capital gains is carried forward for set off against the capital gains of the next succeeding year of assessment: S. 29(6)(ii).

Unabsorbed capital loss on the death of an individual or of a company which is liquidated can be set off against other sources of income in the last year of assessment and any excess can be carried back in the order of recession for three years of assessment preceeding the last year of assessment.

25. Set off of Capital Loss on Death: S. 29(6)(d);

Where a person dies and he has any capital loss for the last year of assessment for which he was liable to be assessed for income tax, such capital loss can be set off against his statutory income from all sources from such last year of assessment.

Any capital loss which cannot be fully set off from the last year of assessment can be set off in the order of recession from the statutory income from

1. 40 of 1981.

all sources of income against any of the three years of assessment preceeding the last year of assessment.

Assessments already made will be amended notwithstanding that they are final and conclusive and tax paid will be refunded to the Executor of the deceased person or such person who is entitled to it.

26. Set off of Capital Loss of a Company which is liquidated. S. 29(6)(d)(iii).[1]

Where a company is liquidated and such company has any capital loss for the last year of assessment for which it was liable to be assessed to income tax shall be deducted from the statutory income of such last year of assessment. Where the capital loss cannot be deducted from the last year of assessment, such capital loss can be carried back for three years of assessment in order of recession immediately preceeding such last year of assessment.

The assessments will be revised taking into account the capital loss and any tax which is found to have been paid in excess will be refunded notwithstanding that these assessments are final and conclusive. S. 29(6)(d)(iv).

1. 40 of 1981.

Chapter 21

CHARGES OR ANNUITIES

Charges or annuities are sources of income chargeable with income tax in the hands of the person receiving such charge or annuity. S. 3(f). The amount chargeable with income tax is the full amount without any deduction for any outgoings and expenses.

Annuity usually involves the purchase of income by payment of a capital sum. Although the annuity received is partly of the capital sum paid the payment would be in the nature of income as the capital has ceased to exist. Annuity has been defined by Baron Watson J. in the case of *Foley v. Fletcher* (1858) 3 H & 769 as:

> "An annuity means where an income is purchased with a sum of money, and the capital has gone and has ceased to exist, the principal having been converted into annuity."

A contract to pay an annuity may be entered into for valuable and sufficient consideration or for the life of the annuitant. It must, however, be noted that such annuities which are payable for a period not exceeding six years no deduction will be permitted to be made from a person's statutory income unless such an annuity is for valuable and sufficient consideration or is for the life of an annuitant. S. 29(2)(a)(v).[1]

1. Income under Charges

A charge is usually an annual payment which is secured on the income or the property of another person. The charge can arise out of any legal obligation created or as a result of any court order and is charged on the income or property of another person. The person receiving any sum will be liable to income tax on the amount received by him as a source of income.

2. Annuity

The scheme of the Inland Revenue Act provides that the person receiving an annuity is chargeable with income tax while the person paying is entitled to deduct such payment from his statutory income. Where the annuity is paid by a person in Sri Lanka to another person in Sri Lanka, the payment is made gross without any deduction for income tax. Where any person in Sri Lanka pays an annuity to any person or partnership out of Sri Lanka, he is entitled to deduct income tax at $33\frac{1}{3}\%$ or at such rates as the Commissioner General may direct. S. 81(1). The person receiving the annuity on

1. 24, of 1980.

which tax has been deducted is entitled to set off the amount of the tax deducted against the tax payable by him where such annuity forms part of his assessable income. S. 81(3). In computing the profits of any trade, business, profession or vocation no deductions are permitted in respect of such payments. S. 24(1)(m)

3. Definition of Annuity

There is no definition of Annuity in the Inland Revenue Act. The Oxford English Dictionary gives the following definition of an annuity.

(a) An yearly grant, allowance or income.

(b) The grant of an annual sum of money, for a term of years, for life, or in perpetuity: which differs from rent charges in being primarily chargeable upon the grantor's person, and his heirs if named and not upon specified land.

(c) An investment of money, whereby the investor becomes entitled to receive a series of equal annual payments, which, except in the case of perpetual annuities, include the alternate return of both principal and interest; also, the annual (or for convenience quarterly) payment made.

Samarawickreme J. in the case of *Rajaratnam v. C. I. R.* 3 CTC at page 382 expressed the view that the word annuity is not limited to an annuity purchased with a sum of money but extends to other annual payments. In arriving at this view he examined further definitions of annuity.

"Stroud has the following definition.

'An Annuity is an yearly payment of a certain sum of money granted to another in fee, for life or years, charging the person of the grantor only' (Co. Litt. 1446). Wharton Law Lexicon has, 'an annuity is a fixed sum payable annually either in perpetuity or for any less period."

4. Characteristics of an Annuity

Samarawickreme J. in the case of *Rajaratnam v. C. I. R.* 3 CTC 378 expounded the following characteristics of an annuity.

(1) It must be made with reference to a year though it may be paid in periodic instalments. e.g. quarterly or monthly.

(2) Not be a receipt or accrual of a capital nature to the payee.

(3) be made under a legal obligation.

(4) be either recurrent or capable of recurrence.

(5) be pure income or profit of the payee.

In this case the taxpayer sought to deduct from his statutory income sums paid under the deed of covenant as annuities. The Commissioner of Inland Revenue contended that the word annuity conveyed only a right to receive annual payments which an annuitant had purchased by the expenditure of a capital sum – thus converting his capital into income. The Commissioner relied on the definition of annuity given by Baron Watson J. in the case of *Foley v. Fletcher* (1858) 3 H & 769: "An Annuity means where an income is purchased with a sum of money, and the capital has gone and ceased to exist, the principal having been converted into an annuity."

The Supreme Court held that a right to receive a recurrent annual payment which are income in the hands of the payee can properly be described an annuity even though the payee has not acquired the right by purchasing it for capital sum but in some other way – (as for example by testamentary bequest or under a voluntary covenant) and that there is no warrant for putting on the word as used in the law a limited meaning.

The Privy Council affirmed the decision of the Supreme Court and held that payments under deeds of convenants can be farily described as "annuities". They further observed that in the case of *I. R. C. v. Duke of Westminister* (1956) AC 1 where the Duke has executed similar covenant in favour of his employees and claimed to deduct the payments under them for tax purposes and in their case Lord Tomilon described these payments as annuities.

A deduction on account of annuity payable for a period less than six years under a contractual obligation will not be permitted unless such annuity is for valuable and sufficient consideration or is for the life of, the annuitant. S. 29(2)(a)(iv).[1]

5. **Payments of Annual Instalments of Capital**

Monthly payment of the purchase price of property is not annuity. In the case of *C. I. R. v. D. B. J. De Silva* 3 CTC 124, it was held that monthly payment of sums stipulated for in an agreement were in reality part of the purchase price of a business and therefore constituted payment of a capital nature and not payment by way of annuity. In this case there was an agreement to sell at an ascertainable or ascertained price to be paid wholly or in part by instalments.

In the case of *Nillgiriya v. C. I. R.* 3 CTC 45, a surviving partner bought the goodwill of the partnership at the agreed valuation and agreed to pay fixed monthly instalments which eventually would equal the sum agreed as the purchase price. It was held that this payment is of a capital nature in that there was no disappearance of the sum agreed, to constitute an annuity payment.

1. 24 of 1980

Chapter 22

OTHER SOURCES OF INCOME

Other sources of income which are enumerated in the Inland Revenue Act as profits and income chargeable with tax are:

(a) Discounts;
(b) Royalties;
(c) Premiums;
(d) Any other sources of income.

(a) Discounts

Discounts as a source of income arise or is derived on the discounting of Bills of Exchange, Cheques or other negotiable instruments. Where discounts are derived in the normal course of business, for example, by a banker, the profits are assessable as profits of a trade.

(b) Royalties

Royalties are payments made by a person for the use of any patent, copyright or mining rights. The person who receives payment of royalty is liable to income tax on such receipts as a separate source of income.

A person carrying on the profession as a writer will be assessable to tax on the receipt of any payment for the copyright as income from the exercise of his profession.

In terms of the section 17 of the Greater Colombo Area Economic Commission Law remittances of royalties by ventures in the Investment Zone will not be liable to any tax for a period of five years from the date of commencement of commercial production. Remitances after the period of five years will be liable to tax at 10%.

Certain royalties are deemed to be profits and income arising in or derived from Sri Lanka if such royalty is:

(a) borne directly or indirectly by a person resident in Sri Lanka; or
(b) is deductible from the statutory income under section 29. S. 80A.[1]

(c) Premiums

Premiums received for lease of properties are liable in the hands of the owner of the property. The premium is distinguished from rent and the

---

1. 40 of 1981.

full amount received is chargeable to income tax. Key money received for letting of houses fall to be classified as a source of income as premium.

There is no particular basis prescribed in the law for the assessment of premiums. Where the payment of premiums cover a period of time extending over one year such payment may be spread over the period in relation to which such payment is made.

(d) Income from any other source

There is no precise definition of the words "profits and income" and the act has enumerated various sources of income as chargeable with income tax. In order to give a wider definition to cover any receipt in the nature of income, a catch-all clause to cover income from any other source whatsoever other than the profits of a casual and non-recurring nature has been provided in the Act. S. 3(i)

Profits of a casual and non-recurring nature are not liable to income tax. Profits of a casual and non-recurring nature would be profits which are not likely to recur again. However, an isolated receipt may be considered profits of a trade where such profits resulted from a transaction which has the characteristics of trading.

Chapter 23

PROFITS FROM SHIPPING AND OPERATION OF AIRCRAFT

The profits of shipping and operation of aircraft is the profits arising from the carriage of passengers, mails, livestock or goods by ship or aircraft shipped or loaded from Sri Lanka. S. 74(1) & 77(1).

1. Basis of Liability

The basis of liability to income tax of the profits from shipping business falls into three headings:

(a) Resident owner or charterer of a ship or aircraft;

(b) Non-resident owner or charterer of a ship;

(c) Non-resident owner or charterer of an aircraft.

2. Resident owner or charterer of a ship or aircraft

A resident person carrying on the business of shipping or operation of aircraft will be liable to income tax on the profits arising on the inward as well as outward freight earnings from the carriage of passengers mails, livestock or goods. The computation of the profits for the purposes of income tax liability will be determined by applying the law and practice of computing business profits.

3. Non-resident ship owner

Where a non-resident person carries on the business of a ship owner or charterer and any ship owned or chartered by him call at any port in Sri Lanka, the full profits arising from the carriage of passengers, mails, livestock and goods shipped in Sri Lanka shall be deemed to arise from Sri Lanka. 74(1).

The amount of the profits on which income tax is chargeable on the non-resident ship owner or charterer will be an amount equal to six per-centum of the entire sum receivable on account of the carrying of passengers, mails, livestock and goods shipped in Sri Lanka. S. 74(1).

4. Basis of liability of Non-resident aircraft owner or charterer

The profit/loss arising to the owner or charterer of an aircraft from the carriage of passengers, mails, livestock or goods in Sri Lanka is determined on the basis of the certificate issued by the income tax authority which assesses the profits of the non-resident person. The profits from the operation of aircraft which is deemed to arise from Sri Lanka is computed as a proportion of the entire profits from operation of aircraft (before charging depreciation) on the basis of the ratio of earnings from Sri Lanka to the world earnings of the non-resident person. That is:

$$\text{Profits from the Operation of Aircraft} = \frac{\text{Gross Earnings from Sri Lanka}}{\text{Gross World Earnings}} \times \text{Total World Profits.}$$

The gross earnings is the sums receivable in respect of the carriage of passengers, mails, livestock or goods loaded into an aircraft. The certificate of the income tax authority which assesses the full profits of the non-resident person from operation of aircraft should certify: S. 77(3).

(a) the ratio of the profits / losses as computed for the purpose of income tax by that authority, before deducting any allowance for depreciation to the total sum receivable in respect of the carriage of passengers, mails, livestock or goods; or

(b) the ratio of allowance for depreciation as computed by that authority to the total sum receivable in respect of the carriage of passengers, mails, livestock and goods.

5. Computation of profits as a fair percentage of earnings from Operation of Aircraft

Where at the time of assessment the ratio certificate of the income tax authority cannot be produced by the non-resident aircraft owner or charterer, the profits arising in Sri Lanka to such non-resident person can be computed on a fair percentage of the amount of the earnings from the operation of aircraft in Sri Lanka. Where an assessment has been made on this basis, the non-resident person is entitled to claim refund of the tax paid in excess at any time within three years of the end of the year of assessment claiming that the income tax liability be computed on the basis of the certificate issued by the income tax authority. S. 77(4). The Commissioner General has determined that in such cases the profits arising from Sri Lanka in respect of the operation of aircraft will be assessed at 15% of the total sum receivable in respect of the carriage of passengers, mails, livestock and goods loaded into aircraft in Sri Lanka.

6. Exemption of shipping profits and profits from operation of aircraft

Profits arising in Sri Lanka of a non-resident ship or aircraft owner or charterer will not be liable to income tax in the following circumstances:-

(a) Where the profits arise from the carriage of goods which are brought into Sri Lanka solely for the purpose of transhipment or solely for transfer from one aircraft to another or from one aircraft to a vessel or from a vessel to an aircraft. S. 74(1) and S. 77(2).

(b) Where the ship which called at a port in Sri Lanka is considered by the Commissioner General as casual and that further calls by that ship or others in the ownership are improbable. S. 74(1).

7. Person chargeable to tax on shipping profits or profits from the operation of aircraft

The Master of any ship or the person having control or charge of an aircraft owned or chartered by a non-resident person is deemed to be the agent of the non-resident person and is chargeable with income tax on behalf of the non-resident person. S. 75

8. Refusal of clearance for non-payment of tax. S. 76.

Where the income tax charged on a non-resident person in respect of the shipping profits or profits from the operation of aircraft has been in default for more than three months, the Commissioner General may issue a certificate containing the name of the person and particulars of income tax default, to the Principal Collector of Customs or authority by whom clearance is granted. Where such a notice has been issued, the Principal Collector of Customs or other authority is empowered to refuse clearance till the tax in default is paid. S. 76(1).

No civil or criminal proceedings can be instituted against the Principal Collector of Customs or other authority in respect of the refusal of clearance. Where a ship or an aircraft has been detained, the non-resident owner or charterer of a ship or aircraft will be liable to all charges, harbour dues, charges on account of landing, stay or housing at a customs aerodrome. S. 76(2).

9. Double tax relief

A non-resident ship, aircraft owner or charterer will be entitled to double tax relief on the basis of agreement reached between the government of the non-resident and the Government of Sri Lanka.

10. Off shore shipping Companies. S. 8(a)(xxxviii)[1]

An off-shore shipping company is exempt from income tax on the profits and income arising to such company from operations of a ship which is;

(a) engaged in international operations;

(b) owned or chartered by such company; and

(c) deemed to be a Ceylon ship on the basis of a determination under section 30(c) of the Merchant Shipping Act No. 52 of 1971.

An off-shore shipping company is not entitled to exemption from income tax in respect of profits and income arising to such company from the carriage by that ship of passengers, mails, livestock and goods, to or from a port in Sri Lanka.

Section 30(c) of the Merchant Shipping Act provides that a ship shall not be deemed to be a Ceylon ship unless it is owned wholly by any body Corporate as may be determined by the Minister. In terms of section 241 of the Companies Act No. 17 of 1982 any company may make an application to the Registrar of Companies to be registered in Sri Lanka as an off-shore company and to be so referred to and in the case of a company incorporated abroad is deemed to be continued in Sri Lanka as if it had been incorporated under the provisions of the Companies Act.

1. 27 of 1982.

Chapter 24

ASCERTAINMENT OF PROFITS AND INCOME

Profits and income means the net profits or income from any source for any period calculated in accordance with the provisions of the Inland Revenue Act S. 163. Income tax, therefore, is charged on net income computed in accordance with the law and practice prevailing. In determining the profit or income commercial principles and practice will be adopted subject to any prohibitions which forbid the deduction of certain specified expenditure.

Whether a particular expenditure is deductible or not will depend generally on commercial and accountancy practice and whether there are any statutory prohibitions against deduction of certain expenditure. Certain expenditure which in commercial and accountancy practice cannot be deducted are specially allowed by statute.

The subject matter covered in this chapter is in respect of the expenses that are deductible or prohibited from deduction in ascertaining profits and income from any trade, business, profession or vocation. The method of computing the income from the following sources have been specifically laid down and these have been discussed elsewhere.

(a) Profits from any employment;
(b) Capital gains;
(c) Rent;
(d) Interest;
(e) Dividends;
(f) Charge, annuity, royalty, discount and premium.

1. Deduction of all outgoings and expenses incurred in the production of income.

In ascertaining the profits and income from any source all outgoings and expenses incurred in the production of income including certain specified expenditure are allowed. S. 23(1). There are thus three classes of expenditure which can be deducted:

(a) all outgoings;
(b) all expenditure incurred in the production of income;
(c) specified deductions.

(a) All outgoings

The meaning of the word 'outgoings' is clearly explained in the judgment of Sinnetamby J., in the case of *Hayley and Co. Ltd. v. C. I. R.* 3 CTC 115;

> "In, therefore, interpreting the expression" outgoings and expenses one must permit such deductions as may reasonably and in a commercial sense be made. in order to ascertain the net profits. The word "outgoings" must not be limited to voluntary payments. It would also include involuntary outgoings such as petty thefts by subordinate officers in the employ of the assessee as well as by outsiders ...... It seems to me that the word "outgoings" is wide enough to cover losses, for losses, after all, is an involuntary outgoing ...... The "outgoing" however, must be outgoings of such a nature as would come within the meaning of the expression "incurred in the production of income ."

In the case of *Hayley and Co. Ltd. v. C. I. R.* 3 CTC 115, the company lost by burglary a large sum of money kept for the purpose of purchasing rubber. It was held that such loss was out of the circulating capital of the company and that the loss was occasioned in the exercise of some step that had to be taken for the conduct of the company's business and must be regarded as a casualty or a misfortune incidental to the company's business. The judge observed that the money in the safe was intended to replenish stock and so long as it is in that safe in that capacity it represented stock in trade and thus its loss would be equivalent to a loss of a stock-in-trade. Thus the loss incurred was something incidental to the assessee's business and any commercial undertaking would deduct such loss from its income in order to ascertain its net profits.

(b) Expenses incurred in the production of income

The pharse "expenditure incurred in the production of income" was considered in the case of *Ward and Co. Ltd. v. C.I.T.* (New Zealand case). The wording is similar to the Sri Lanka Law. In this case expenses incurred in resisting the anti-prohibition drive was held to be expense not exclusively incurred in the production of income. The expenditure in question was not necessary for the production of profits, nor was it incurred for that purpose. It was voluntary expense with a review to influencing public opinion against taking a step which would have destroyed the profit bearing thing. In this case the emphasis was upon the criterion that it is the effect of the expenditure in contributing to the income of the designated source that is to be considered. Thus the allowable expenditure must have been for the purpose of earning the profits. This requirement was regarded by the Privy Council as highly restrictive as it was treated as having the effect of disallowing the expenditure intended to influence public opinion against prohibition, a measure which if introduced would have had a destructive effect upon the profits of the company. Such expenditure though disallowed, was related to the maintenance of the business itself, the failure of its goodwill and the preservation of its profitability at any rate, in a recognisable sense.

The reasoning in this case was followed in the case of *Davith Appuhamy v. C.I.T.* 3 CTC 180. In tnis case the proprietor of the business incurred legal expenditure in defending his right to the ownership of the business against a claim by others that they had a share in the business as partners. The litigation expenses was held to be related to an issue whose outcome would have affected only the respondents share as the owner of the business. Expenses incurred by the proprietor in litigation with other persons as to their respective rights to share in the ownership of the business, cannot be charged against the profits of that business itself.

Business to be treated as separate entity:

The buisness, must be treated as a separate entity which has allocated to it certain assets and certain obligations and the analysis is required in order to ascertain its profits even though there is only one individual who is its owner or proprietor.

"the business must, of course, be treated as a distinct source for the purpose; if it were not it would be impossible to find the basis upon which to identify the receipt, expenditure and other charges attributable to it. The profit emerging is nothing but the figure of the balance that results from setting the expenditure and other charges against the receipts. The task of identifying the source must be approached this way", Lord Radcliff in *Davith Appuhamy v. C.I.T.* 2 CTC 180.

The distinction of the separate entity of the business and the proprietor was also examined in the case of *P. K. N. v. C.I.T.* 1 CTC 50. In this case the assessee was carrying on an import business in Sri Lanka. He also had a shipping business controlled by him in India. The assessee sought to deduct the freight they would have charged other merchants for carrying their goods. It was held that the assessee could only deduct such outgoings or expenses as were actually paid out or became payable in the production of the profits. The assessee was only entitled to deduct such outgoings or expenses as were actually paid out or became payable in the production of these profits and hence the assessee is not entitled to deduct from those profits the amount of the freight which they would have had to pay if the ship did not belong to them. Notional expenses cannot therefore be deducted in ascertaining the profits

Expenditure must be incurred

The expenses that could be claimed must be incurred. Thus expense for services obtained but not paid for could be deducted. In the same manner advance payment for expenses cannot be deducted, in that year. Any provisions for likely loss, or liabilities are also not deductible.

2. **Expenses must be for the purpose of producing income.**

Any disbursement or expenses which are money not expended for the purpose of producing income cannot be deducted in computing income for tax purposes. S. 24(1)(g). The expenses charged must be related to the trade, business. profession or vocation and should not be too remote but must be incidental to these activities.

"It is not enough that the disbursement is made in the course of or arise out of, or is connected with the trade, or made out of the profits of the trade, it must be made for the purpose of earning the profits" Lord Davy in *Strong v Woodifield;* 5 TC 215.

which tax has been deducted is entitled to set off the amount of the tax deducted against the tax payable by him where such annuity forms part of his assessable income. S. 81(3). In computing the profits of any trade, business, profession or vocation no deductions are permitted in respect of such payments. S. 24(1)(m)

3. Definition of Annuity

There is no definition of Annuity in the Inland Revenue Act The Oxford English Dictionary gives the following definition of an annuity.

(a) An yearly grant, allowance or income.

(b) The grant of an annual sum of money, for a term of years, for life, or in perpeturity: which differs from rent charges in being primarily chargeable upon the grantor's person, and his heirs if named and not upon specified land.

(c) An investment of money, whereby the investor becomes entitled to receive a series of equal annual payments, which, except in the case of perpetual annuities, include the alternate return of both principal and interest; also, the annual (or for convenience quarterly) payment made.

Samarawickreme J. in the case of *Rajaratnam v. C. I. R.* 3 CTC at page 382 expressed the view that the word annuity is not limited to an annuity purchased with a sum of money but extends to other annual payments. In arriving at this view he examined further definitions of annuity.

"Stroud has the following definition.

'An Annuity is an yearly payment of a certain sum of money granted to another in fee, for life or years, charging the person of the grantor only' (Co. Litt. 1446). Wharton Law Lexicon has, 'an annuity is a fixed sum payable annually either in perpetuity or for any less period."

4. Characteristics of an Annuity

Samarawickreme J. in the case of *Rajaratnam v. C. I. R.* 3 CTC 378 expounded the following characteristics of an annuity.

(1) It must be made with reference to a year though it may be paid in periodic instalments. e.g. quarterly or monthly.

(2) Not be a receipt or accrual of a capital nature to the payee.

(3) be made under a legal obligation.

(4) be either recurrent or capable of recurrence.

(5) be pure income or profit of the payee.

In this case the taxpayer sought to deduct from his statutory income sums paid under the deed of covenant as annuities. The Commissioner of Inland Revenue contended that the word annuity conveyed only a right to receive annual payments which an annuitant had purchased by the expenditure of a capital sum – thus converting his capital into income. The Commissioner relied on the definition of annuity given by Baron Watson J. in the case of *Foley v. Fletcher* (1858) 3 H & 769: "An Annuity means where an income is purchased with a sum of money, and the capital has gone and ceased to exist, the principal having been converted into an annuity."

The Supreme Court held that a right to receive a recurrent annual payment which are income in the hands of the payee can properly be described an annuity even though the payee has not acquired the right by purchasing it for capital sum but in some other way – (as for example by testamentary bequest or under a voluntary covenant) and that there is no warrant for putting on the word as used in the law a limited meaning.

The Privy Council affirmed the decision of the Supreme Court and held that payments under deeds of convenants can be farily described as "annuities". They further observed that in the case of *I. R. C. v. Duke of Westminister* (1956) AC 1 where the Duke has executed similar covenant in favour of his employees and claimed to deduct the payments under them for tax purposes and in their case Lord Tomilon described these payments as annuities.

A deduction on account of annuity payable for a period less than six years under a contractual obligation will not be permitted unless such annuity is for valuable and sufficient consideration or is for the life of, the annuitant. S. 29(2)(a)(iv).[1]

5. Payments of Annual Instalments of Capital

Monthly payment of the purchase price of property is not annuity. In the case of *C. I. R. v. D. B. J. De Silva* 3 CTC 124, it was held that monthly payment of sums stipulated for in an agreement were in reality part of the purchase price of a business and therefore constituted payment of a capital nature and not payment by way of annuity. In this case there was an agreement to sell at an ascertainable or ascertained price to be paid wholly or in part by instalments.

In the case of *Nillgiriya v. C. I. R.* 3 CTC 45, a surviving partner bought the goodwill of the partnership at the agreed valuation and agreed to pay fixed monthly instalments which eventually would equal the sum agreed as the purchase price. It was held that this payment is of a capital nature in that there was no disappearance of the sum agreed, to constitute an annuity payment.

1. 24 of 1980

Chapter 22

OTHER SOURCES OF INCOME

Other sources of income which are enumerated in the Inland Revenue Act as profits and income chargeable with tax are:

(a) Discounts;
(b) Royalties;
(c) Premiums;
(d) Any other sources of income.

(a) Discounts

Discounts as a source of income arise or is derived on the discounting of Bills of Exchange, Cheques or other negotiable instruments. Where discounts are derived in the normal course of business, for example, by a banker, the profits are assessable as profits of a trade.

(b) Royalties

Royalties are payments made by a person for the use of any patent, copyright or mining rights. The person who receives payment of royalty is liable to income tax on such receipts as a separate source of income.

A person carrying on the profession as a writer will be assessable to tax on the receipt of any payment for the copyright as income from the exercise of his profession.

In terms of the section 17 of the Greater Colombo Area Economic Commission Law remittances of royalties by ventures in the Investment Zone will not be liable to any tax for a period of five years from the date of commencement of commercial production. Remitances after the period of five years will be liable to tax at 10%.

Certain royalties are deemed to be profits and income arising in or derived from Sri Lanka if such royalty is:

(a) borne directly or indirectly by a person resident in Sri Lanka; or
(b) is deductible from the statutory income under section 29. S. 80A.[1]

(c) Premiums

Premiums received for lease of properties are liable in the hands of the owner of the property. The premium is distinguished from rent and the

1. 40 of 1981.

full amount received is chargeable to income tax. Key money received for letting of houses fall to be classified as a source of income as premium.

There is no particular basis prescribed in the law for the assessment of premiums. Where the payment of premiums cover a period of time extending over one year such payment may be spread over the period in relation to which such payment is made.

(d) **Income from any other source**

There is no precise definition of the words "profits and income" and the act has enumerated various sources of income as chargeable with income tax. In order to give a wider definition to cover any receipt in the nature of income, a catch-all clause to cover income from any other source whatsoever other than the profits of a casual and non-recurring nature has been provided in the Act. S. 3(i)

Profits of a casual and non-recurring nature are not liable to income tax. Profits of a casual and non-recurring nature would be profits which are not likely to recur again. However, an isolated receipt may be considered profits of a trade where such profits resulted from a transaction which has the characteristics of trading.

Chapter 23

PROFITS FROM SHIPPING AND OPERATION OF AIRCRAFT

The profits of shipping and operation of aircraft is the profits arising from the carriage of passengers, mails, livestock or goods by ship or aircraft shipped or loaded from Sri Lanka. S. 74(1) & 77(1).

1. Basis of Liability

The basis of liability to income tax of the profits from shipping business falls into three headings:

(a) Resident owner or charterer of a ship or aircraft;

(b) Non-resident owner or charterer of a ship;

(c) Non-resident owner or charterer of an aircraft.

2. Resident owner or charterer of a ship or aircraft

A resident person carrying on the business of shipping or operation of aircraft will be liable to income tax on the profits arising on the inward as well as outward freight earnings from the carriage of passengers mails, livestock or goods. The computation of the profits for the purposes of income tax liability will be determined by applying the law and practice of computing business profits.

3. Non-resident ship owner

Where a non-resident person carries on the business of a ship owner or charterer and any ship owned or chartered by him call at any port in Sri Lanka, the full profits arising from the carriage of passengers, mails, livestock and goods shipped in Sri Lanka shall be deemed to arise from Sri Lanka. 74(1).

The amount of the profits on which income tax is chargeable on the non-resident ship owner or charterer will be an amount equal to six per-centum of the entire sum receivable on account of the carrying of passengers, mails, livestock and goods shipped in Sri Lanka. S. 74(1).

4. Basis of liability of Non-resident aircraft owner or charterer

The profit/loss arising to the owner or charterer of an aircraft from the carriage of passengers, mails, livestock or goods in Sri Lanka is determined on the basis of the certificate issued by the income tax authority which assesses the profits of the non-resident person. The profits from the operation of aircraft which is deemed to arise from Sri Lanka is computed as a proportion of the entire profits from operation of aircraft (before charging depreciation) on the basis of the ratio of earnings from Sri Lanka to the world earnings of the non-resident person. That is:

$$\text{Profits from the Operation of Aircraft} = \frac{\text{Gross Earnings from Sri Lanka}}{\text{Gross World Earnings}} \times \text{Total World Profits.}$$

The gross earnings is the sums receivable in respect of the carriage of passengers, mails, livestock or goods loaded into an aircraft. The certificate of the income tax authority which assesses the full profits of the non-resident person from operation of aircraft should certify: S. 77(3).

(a) the ratio of the profits / losses as computed for the purpose of income tax by that authority, before deducting any allowance for depreciation to the total sum receivable in respect of the carriage of passengers, mails, livestock or goods; or

(b) the ratio of allowance for depreciation as computed by that authority to the total sum receivable in respect of the carriage of passengers, mails, livestock and goods.

5. Computation of profits as a fair percentage of earnings from Operation of Aircraft

Where at the time of assessment the ratio certificate of the income tax authority cannot be produced by the non-resident aircraft owner or charterer, the profits arising in Sri Lanka to such non-resident person can be computed on a fair percentage of the amount of the earnings from the operation of aircraft in Sri Lanka. Where an assessment has been made on this basis, the non-resident person is entitled to claim refund of the tax paid in excess at any time within three years of the end of the year of assessment claiming that the income tax liability be computed on the basis of the certificate issued by the income tax authority. S. 77(4). The Commissioner General has determined that in such cases the profits arising from Sri Lanka in respect of the operation of aircraft will be assessed at 15% of the total sum receivable in respect of the carriage of passengers, mails, livestock and goods loaded into aircraft in Sri Lanka.

6. Exemption of shipping profits and profits from operation of aircraft

Profits arising in Sri Lanka of a non-resident ship or aircraft owner or charterer will not be liable to income tax in the following circumstances:-

(a) Where the profits arise from the carriage of goods which are brought into Sri Lanka solely for the purpose of transhipment or solely for transfer from one aircraft to another or from one aircraft to a vessel or from a vessel to an aircraft. S. 74(1) and S. 77(2).

(b) Where the ship which called at a port in Sri Lanka is considered by the Commissioner General as casual and that further calls by that ship or others in the ownership are improbable. S. 74(1).

7. **Person chargeable to tax on shipping profits or profits from the operation of aircraft**

The Master of any ship or the person having control or charge of an aircraft owned or chartered by a non-resident person is deemed to be the agent of the non-resident person and is chargeable with income tax on behalf of the non-resident person. S. 75

8. **Refusal of clearance for non-payment of tax.** S. 76.

Where the income tax charged on a non-resident person in respect of the shipping profits or profits from the operation of aircraft has been in default for more than three months, the Commissioner General may issue a certificate containing the name of the person and particulars of income tax default, to the Principal Collector of Customs or authority by whom clearance is granted. Where such a notice has been issued, the Principal Collector of Customs or other authority is empowered to refuse clearance till the tax in default is paid. S. 76(1).

No civil or criminal proceedings can be instituted against the Principal Collector of Customs or other authority in respect of the refusal of clearance. Where a ship or an aircraft has been detained, the non-resident owner or charterer of a ship or aircraft will be liable to all charges, harbour dues, charges on account of landing, stay or housing at a customs aerodrome. S. 76(2).

9. **Double tax relief**

A non-resident ship, aircraft owner or charterer will be entitled to double tax relief on the basis of agreement reached between the government of the non-resident and the Government of Sri Lanka.

10. **Off shore shipping Companies.** S. 8(a)(xxxviii)[1]

An off-shore shipping company is exempt from income tax on the profits and income arising to such company from operations of a ship which is;

(a) engaged in international operations;

(b) owned or chartered by such company; and

(c) deemed to be a Ceylon ship on the basis of a determination under section 30(c) of the Merchant Shipping Act No. 52 of 1971.

An off-shore shipping company is not entitled to exemption from income tax in respect of profits and income arising to such company from the carriage by that ship of passengers, mails, livestock and goods, to or from a port in Sri Lanka.

Section 30(c) of the Merchant Shipping Act provides that a ship shall not be deemed to be a Ceylon ship unless it is owned wholly by any body Corporate as may be determined by the Minister. In terms of section 241 of the Companies Act No. 17 of 1982 any company may make an application to the Registrar of Companies to be registered in Sri Lanka as an off-shore company and to be so referred to and in the case of a company incorporated abroad is deemed to be continued in Sri Lanka as if it had been incorporated under the provisions of the Companies Act.

1. 27 of 1982

Chapter 24

ASCERTAINMENT OF PROFITS AND INCOME

Profits and income means the net profits or income from any source for any periodcalculated in accordance with the provisions of the Inland Revenue Act S. 163. Income tax, therefore, is charged on net income computed in accordance with the law and practice prevailing. In determining the profit or income commercial principles and practice will be adopted subject to any prohibitions which forbid the deduction of certain specified expenditure.

Whether a particular expenditure is deductible or not will depend generally on commercial and accountancy practice and whether there are any statutory prohibitions against deduction of certain expenditure. Certain expenditure which in commercial and accountancy practice cannot be deducted are specially allowed by statute.

The subject matter covered in this chapter is in respect of the expenses that are deductible or prohibited from deduction in ascertaining profits and income from any trade, business, profession or vocation. The method of computing the income from the following sources have been specifically laid down and these have been discussed elsewhere.

(a) Profits from any employment;
(b) Capital gains;
(c) Rent;
(d) Interest,
(e) Dividends:
(f) Charge, annuity, royalty, discount and premium.

1. Deduction of all outgoings and expenses incurred in the production of income.

In ascertaining the profits and income from any source all outgoings and expenses incurred in the production of income including certain specified expenditure are allowed. S. 23(1). There are thus three classes of expenditure which can be deducted:

(a) all outgoings;
(b) all expenditure incurred in the production of income;
(c) specified deductions.

(a) **All outgoings**

The meaning of the word 'outgoings' is clearly explained in the judgment of Sinnetamby J., in the case of *Hayley and Co. Ltd. v. C. I. R.* 3 CTC 115;

> "In, therefore, interpreting the expression" outgoings and expenses one must permit such deductions as may reasonably and in a commercial sense be made. in order to ascertain the net profits. The word "outgoings" must not be limited to voluntary payments. It would also include involuntary outgoings such as petty thefts by subordinate officers in the employ of the assessee as well as by outsiders ...... It seems to me that the word "outgoings" is wide enough to cover losses, for losses, after all, is an involuntary outgoing ...... The "outgoing" however, must be outgoings of such a nature as would come within the meaning of the expression "incurred in the production of income ."

In the case of *Hayley and Co. Ltd. v. C. I. R.* 3 CTC 115, the company lost by burglary a large sum of money kept for the purpose of purchasing rubber. It was held that such loss was out of the circulating capital of the company and that the loss was occasioned in the exercise of some step that had to be taken for the conduct of the company's business and must be regarded as a casualty or a misfortune incidental to the company's business. The judge observed that the money in the safe was intended to replenish stock and so long as it is in that safe in that capacity it represented stock in trade and thus its loss would be equivalent to a loss of a stock-in-trade. Thus the loss incurred was something incidental to the assessee's business and any commercial undertaking would deduct such loss from its income in order to ascertain its net profits.

(b) **Expenses incurred in the production of income**

The pharse "expenditure incurred in the production of income" was considered in the case of *Ward and Co. Ltd. v. C.I.T.* (New Zealand case). The wording is similar to the Sri Lanka Law. In this case expenses incurred in resisting the anti-prohibition drive was held to be expense not exclusively incurred in the production of income. The expenditure in question was not necessary for the production of profits, nor was it incurred for that purpose. It was voluntary expense with a review to influencing public opinion against taking a step which would have destroyed the profit bearing thing. In this case the emphasis was upon the criterion that it is the effect of the expenditure in contributing to the income of the designated source that is to be considered. Thus the allowable expenditure must have been for the purpose of earning the profits. This requirement was regarded by the Privy Council as highly restrictive as it was treated as having the effect of disallowing the expenditure intended to influence public opinion against prohibition, a measure which if introduced would have had a destructive effect upon the profits of the company. Such expenditure though disallowed, was related to the maintenance of the business itself, the failure of its goodwill and the preservation of its profitability at any rate, in a recognisable sense.

The reasoning in this case was followed in the case of *Davith Appuhamy v. C.I.T.* 3 CTC 180. In this case the proprietor of the business incurred legal expenditure in defending his right to the ownership of the business against a claim by others that they had a share in the business as partners. The litigation expenses was held to be related to an issue whose outcome would have affected only the respondents share as the owner of the business. Expenses incurred by the proprietor in litigation with other persons as to their respective rights to share in the ownership of the business, cannot be charged against the profits of that business itself.

Business to be treated as separate entity:

The buisness, must be treated as a separate entity which has allocated to it certain assets and certain obligations and the analysis is required in order to ascertain its profits even though there is only one individual who is its owner or proprietor.

"the business must, of course, be treated as a distinct source for the purpose: if it were not it would be impossible to find the basis upon which to identify the receipt, expenditure and other charges attributable to it. The profit emerging is nothing but the figure of the balance that results from setting the expenditure and other charges against the receipts. The task of identifying the source must be approached this way", Lord Radcliff in *Davith Appuhamy v. C.I.T.* 2 CTC 180.

The distinction of the separate entity of the business and the proprietor was also examined in the case of *P. K. N. v. C.I.T.* 1 CTC 50. In this case the assessee was carrying on an import business in Sri Lanka. He also had a shipping business controlled by him in India. The assessee sought to deduct the freight they would have charged other merchants for carrying their goods. It was held that the assessee could only deduct such outgoings or expenses as were actually paid out or became payable in the production of the profits. The assessee was only entitled to deduct such outgoings or expenses as were actually paid out or became payable in the production of these profits and hence the assessee is not entitled to deduct from those profits the amount of the freight which they would have had to pay if the ship did not belong to them. Notional expenses cannot therefore be deducted in ascertaining the profits

Expenditure must be incurred

The expenses that could be claimed must be incurred. Thus expense for services obtained but not paid for could be deducted. In the same manner advance payment for expenses cannot be deducted, in that year. Any provisions for likely loss, or liabilities are also not deductible.

2. **Expenses must be for the purpose of producing income.**

Any disbursement or expenses which are money not expended for the purpose of producing income cannot be deducted in computing income for tax purposes. S. 24(1)(g). The expenses charged must be related to the trade, business, profession or vocation and should not be too remote but must be incidental to these activities.

"It is not enough that the disbursement is made in the course of or arise out of, or is connected with the trade, or made out of the profits of the trade, it must be made for the purpose of earning the profits" Lord Davy in *Strong v Woodifield;* 5 TC 215.

In this case damages payable to a hotel guest for injury he sustained while in the hotel was held to be an expense unconnected with the trade and therefore not deductible. The reasoning was:

"...... the loss sustained by the appellant was not really incidental to their trade as inkeepers and fell upon them in their character not of as traders, but of householders." – Lord Loreburn in the case of *Strong v. Woodifield;* 5 TC 215.

General Principles of ascertaining profits

The general principles applied in arriving at the profits liable to income tax may be illustrated by the following quotations from the case of *Ushers' Wiltshire Brewery Ltd. v. Bruce:* 6 TC 399.

Lord Loreburn:

"Profits and gains must be estimated on ordinary principles of commercial trading by setting against the income earned the cost of earning it subject to the limitations presented by the Act" ......

Lord Summer:

"The effect of this structure, I think is this, that the direction to compute the full amount of the balance of profits must be read as subject to certain allowances and to certain prohibitions of deductions, but that a deduction ...... which is neither within the term of the prohibition nor such that the expressed allowance must be taken as the exclusive definition of the area is one to be made or not to be made according as it is or is not, on the facts of the case a proper debit item to be charged against the incomings of the trade when computing the balance of profits of it".

Lord Parmoor:

"The balance of the profits and gains of a trade is struck by setting against the receipts all expenditure incidental to the trade which is necessary to earn them and by applying, in the computation, the ordinary principles of commercial trading".

Evidence of accountants is generally followed and may be relevant in deciding whether an expense on the basis of accountancy practice is a proper debit but such an evidence is not conclusive or binding.

"The courts have always been assisted greatly by the evidence of accountants. Their practice should be given due weight but the courts have never regarded themselves as being bound by it. It would be wrong to do so. The question of what is capital and what is revenue is a question of law for the courts. They are not to be deflected from their true course by the evidence of accountants however eminent" Lord Dennings M. R. in the case of *Heather v. P. E. Consulting Group Ltd.* 48 TC 293.

3. Allowance for Depreciation

Depreciation is recognised as an outgoing in accountancy practice and methods of providing for depreciation have been recommended by the accountancy bodies. The allowance for depreciation that can be deducted in computing the profits for tax purposes are prescribed under the Revenue Laws. The Revenue Law provides for the deduction of an allowance for depreciation by wear and tear arising out of their use in a trade, business, profession or vocation in respect of:

(a) plant, machinery and fixtures calculated at a fixed rate *per centum* per annum on the cost of acquisition: S. 23(1)(e).[1]

(b) on qualified buildings at fixed rate on the cost of construction: S. 23(1)(e).[1]

(c) on any unit of non-residential accommodation comprised in a registered Condimonium Property at fixed rate on the cost of acquisition: S. 23(1)(ee).[2]

(d) any furniture utensils or articles for use in operating or providing building for approved tourist undertakings on the full amount expended on purchase: S. 23(1)(s)(i).[3]

(e) any implement or equipment for any undertaking of deep sea or off-shore fishing on the full amount expended on the purchase: S. 23(1)(d)(ii).

(f) on vehicles for travelling in respect of:

(i) motor-cycles or bicycles used by employees other than executive employees at prescribed rates;

(ii) motor coaches used for the transporation of employees to and from their place of work at prescribed rate of depreciation: S. 24(2).[4]

(g) on new Ominibuses acquired before March 31. 1983 and used for public transport at prescribed rate of depreciation. (Prescribed by Commissioner General)

The rates of depreciation prescribed by the Commissioner General as applicable from April 01, 1981 are as follows:

(1) **Plant Machinery & Fixtures:**

(a) Plant, Machinery & Fixtures **Acquired after April 01, 1981**[4] will be granted depreciation on the straight line method as follows:

(i) The following items qualify for the depreciation allowance @ 25%:-

Air Compressor
Electronic Computer
Excavator (Diesel)
Lilliput Dredger (Diesel)
Mining – Caterpillar (Diesel Air Compressor)
Motor vehicle (includes car, jeep, land-rover, lorry, truck, mini-moke, motor cycle, scooter station wagon, van, pick up, motor coach)
Refrigerator
Saw-chain, Petrol driven
Scraper
Steam Wagon
Sulphur Dusting Machine (worked by motor)
Tank Lorry

---

1 24 of 1980. 2. 27 of 1982 3. 40 of 1981 4. 24 of 1980.

Tractor (Diesel)
Tractor (Kerosine)
Tractor (Petrol)
Trencher Bucket (Diesel)
Types and Blocks
Wireless receiving set

(ii) All other plant, machinery and fixtures $12\frac{1}{2}\%$.

(2) **Buildings**:

An allowance for depreciation will be granted on the straight line method at 5% per annum in respect of qualified buildings constructed after April 01, 1981 for use in a trade, business, profession, or vocation (other than as a dwelling house for executives).

(3) **Omnibuses used for public transport**:

(a) For period 01.04.1982 to 31.03.1983 – 75%
(b) For period 01.04.1983 to 31.03.1984 – 25%

4. **The scheme of depreciation allowance.**

The scheme of depreciation allowance which are permitted to be deducted in computing profits liable to income tax provide for the writing off the cost of such assets over a period of time at a fixed rate percent. In the case of certain assets used in an approved tourist undertaking or undertaking of deep-sea or offshore fishing the amount spent on the purchase of such assets are permitted to be written off as a once and for all allowance in the year of purchase.

Where a capital asset on which depreciation allowance equal to the cost has been granted is sold the sale price or the market value of that asset where such asset is diposed of otherwise than by sale will be treated as profits. S. 23(3)(a). In the case of assets where the total of the allowances for depreciation granted is less than the cost of such asset, the excess of the sale price or the market value, if sold otherwise than by sale, over the difference between the cost and depreciation allowance granted, will be treated as profit or loss as the case may be. S. 23(3)(b).

In order to be entitled for an allowance for depreciation, the plant, machinery or fixtures must be acquired by such person and the depreciation must be due to wear and tear arising out of their use in a trade, business, profession, or vocation carried on by that person. In the case of buildings such buildings must be qualified buildings constructed by that person for use in a trade, business, profession or vocation carried on by that person. The depreciation allowance, therefore, is due to the owner user and will not be available to a person hiring such plant, machinery or fixtures or leasing a building. However, in the case of a person carrying on the business of hiring plant, machinery or fixtures in the course of carrying on the business as hirer, will be entitled to claim an allowance for depreciation.

The amount of the depreciation allowance is deducted annually till the full cost is depreciated. The depreciation allowance granted shall not exceed the cost of such assets. S. 23(1)(e) Proviso (ii).

5. Wear and Tear.

The allowance permitted is the depreciation by wear and tear of the assets in the course of their constant use. The diminished value by effluxion of time is not depreciation by reason of wear and tear.

"The diminished value, by reason of the efflux of time year by year of an animal or a tree does not seem to me to be diminished value by reason of wear and tear. It is simply diminished value because you have invested your money in a source of production which is a wasting source of production and I think it is not within these words." Rowlatt J. in *Earl of Derby v. C.I.R.* 6 TC 665.

In this case, the decreased value of stallions at stud due to effluxion of time was held not depreciation by reason of wear and tear.

6. Plant, Machinery or Fixtures:

The allowance for depreciation that is permitted to be deducted is calculated on the straight line method applying the rate of depreciation prescribed by the Commissioner General. The allowance can be claimed commencing from the year in which the asset is first used. Where the asset is purchased in one and used in the subsequent year, the allowance can be claimed commencing from the year in which it was first used and not in the year in which it was acquired.

The depreciation can only be claimed in respect of assets which come within the description of plant, machinery or fixtures. The fixtures that qualify for depreciation allowance would generally apply only to fixtures that are permanently attached to a building. The words plant and machinery is not defined in the Act and would have its normal meaning. The word plant has wider meaning and has found some judicial definition.

What is Plant?

A definition of plant has been expounded by Lindlay L.J. in the case of *Yarmouth v. France* 19 QBD 647 has been received with approval by the House of Lords as an accurate description of plant for income tax purposes in the case of *Hinton v. Maden & Ireland Ltd.* 38 TC 391.

"Plant in its ordinary sense, includes whatever apparatus is used by a business man for carrying on of his business not his stock in trade which he buys or makes for sale, but all goods and chattels, fixed and movable, live or dead, which he keeps for permanent employment in his business."

This definition was given by the learned judge in a rating case brought to decide whether a horse used for transaction was plant. In this case the term plant was considered to be wide enough to cover animals unless such animals was part of the stock in trade. However, in the case of *Derbey v. Aylmer* 6 TC 665 Stallions at stud was not considered as plant. The decision was on the basis the annual decrease in value of the stallions was solely due to effluxion of time and not due to wear and tear.

In *Nuttley and Finn* (1894) Weekly Notes 64: Kekewich J. said:

"...... as speaking generally, 'Machinery' included everything which by its action produces or assists in production, so 'Plant' might be regarded as that without which production could not go on. It was so to speak, dead stock, it did not itself act, but was that through and by means of, and in which, action took place, and included such things as brewers pipes, vats and the like" ...... See *Thornhill v. C.I.T.* 1 CTC at 137.

In order to decide the difficult question of what is plant courts have been guided by the test whether the object described as plant performs any operation or a function or that the object is part of the setting in which the trade or business is carried on. Where it is found that the object is an apparatus or performs or fulfils the function it will be considered plant. And where, that part of the structure or object is the setting in which the business is carried on, then such structure or object cannot be plant.

"The conjunction of "Machinery" and "Plant" suggest to me that they both must perform some active function. In order to decide whether a particular object is an apparatus it seems obvious that an enquiry has to be made as to what operation it performs. The functional test is, therefore, essential at any rate as a preliminary." Lord Guest: *Barclay, Curle & Co., Ltd. v. C.I.R.* 45 TC 221.

The distinction between what is part of the premises and what is part of a plant has been made by Lord Guest in *Barclay Curle & Co. Ltd. v. C.I.R.* 45 TC 221.

"The factory is by itself a building or structure in which trade can be carried on. But the excavation and concrete work is useless for any trade purpose unless used in conjunction with the rest of the equipment."

Lord Reid anlaysed the function of the dry dock and came to the conclusion that the dry dock was the means by which or the plant with which the operation was performed. He drew the distinction of the dry dock from a dam.

"Clearly land in its natural form is not plant, although its configuration may be such that use is an essential element in a trading operation. The soil on the farm is not plant, although cultivation has greatly improved it. So a loch which impounds water is not plant, although a trader uses it as the source of the water he needs and a dam is generally simply an improvement of the loch giving a better supply. But I could imagine circumstances in which a dam would be such an integral part of the means required for a trading operation that it should be regarded as plant."

In the case of swimming pool at a Caravan park the cost of providing filtration, heating and recirculation of water and of the plumbing, the fitting of the electrical installations were accepted as machinery and plant including the cost of terracing, pool construction and excavation: *Cooke v, Beach Stations Caravans Ltd.* 49 TC 514. The basis of decision was;

"I do not think the pools can be regarded as passive ...... The purpose of the pool is to provide ...... a medium in which the visitors to the Caravan park can safely disport themselves ...... If I may use a relatively modern slang expression the pools were not merely 'where its at' they are part of the apparatus used by the company for carrying on its business as a Caravan park operator." Justice Megarry.

In the case of *Wangaratta Woollen Mills Ltd.* (Australian case) a dye-house was held to be plant. The judge observed that the dye-house is in the nature of a tool and should be regarded as a single unit of plant and not a collection of bricks and mortar.

A dockside grain silos of a grain importer was held to be plant *Shoefield v. R & H Hall Ltd.* 49 TC 538: on considering the relation to the trading activities as a whole the silos were not mere shelter for men or grain. In the case of *Eixon v. Fitch's Garage* (1974) where a canopy over a garage service area was held not plant on the ground that the canopy did not have any funcitonal purpose.

In the case of *Cole Brothers Ltd. v. Phillips* S.T.C. 671 (1981) where a switchboard was held to be plant. The switch board controlled the electric lighting, heating, ventilation, fire alarm circuits, lifts escalations, cash registers all of which were agreed as plant.

"...... in the light of this it does seem ...... difficult to argue either that the wiring is agreed and found to be plant can be segregated from the attendant control switches or that the size and nature of the switchboard was not dictated by the necessity to incorporate into it those control switches". – Olikers L.S.

In *I.R.C. v. Scottish and Newcastle Breweries:* S.T.C. 50 (1981) light fittings, decor, and murals were considered appartus and not as part of the setting.

"In the present case, that of a company engaged in a service industry, it can be fairly and accurately said that ...... atmosphere ...... is one of the services which the company offers ...... The items of decor were acquired and were in a reasonable sense used to manufacture atmosphere and in that sense were in my view clearly part of the apparatus used by the company for carrying on its business ......" – Lord Cameron.

Movable partitions which could be rearranged to produce different divisions of the floor space as required was held to be plant *Jarrold v. Jhon Good & Sons Ltd.* 40 TC 681. In *Hinton v. Maden and Ireland Ltd.* 38 TC 397 the House of Lords held that knives and lasts used by shoe manufacturers, which were numerous and cheap with an average life of three years as plant.

The law books purchased by a barrister for the purpose of setting up a practice was held to be plant in the case of *Munby v. Furlong* (1976) I.W.L.R. 410 on the basis that books are part of the apparatus used by a professional man to carry on his profession.

"If a barrister has to buy a new edition of a text book in order to help him to write his opinions, I cannot see as a matter of principle why the books should not be regarded as a tool of his trade just as much as the typewriter on which his opinions are typed." – Cross J.

7. **Qualified Buildings.**

A person is entitled to an allowance for depreciation by wear and tear at 5% on;

(a) the cost of construction of qualified buildings;

(b) the cost of acquisition of non-residential accommodation comprised in a registered condominium property; on or after April 01, 1981. S. 23(1)(ee).[1]

for use in a trade, business, profession or vocation. Depreciation allowance is not available in respect of building used as a dwelling house for an executive officer.

Qualified building means a building constructed for use for the purpose of a trade, business, profession or vocation other than for use as a dwelling house by an executive. S. 23(7)(e). The term "for the purpose of a trade" has not been defined in the Act and would carry the normal meaning depending on the facts of the case and buildings which are necessarily required for the trade or business activities will qualify for the allowance.

A distinction must be made between expenditure on plant and machinery and expenditure on buildings. Some of the items which are normally found in a building used for the purpose of a trade or business may fall between the dividing line of building or plant and machinery.

Where the construction of a building which qualify for depreciation allowance was commenced prior to April 01, 1981, the cost of construction up to March 31, 1981 will qualify for depreciation at 50% of cost incurred up to March 31, 1981. The balance of the expenditure incurred after April 01, 1981 will qualify for depreciation at 5% of the cost of construction incurred after that date.

Where a building the construction of which was commenced prior to April 01, 1981 and completed after that date is sold the profit or loss on the disposal of such building is computed on the following basis:

Profit or Loss = Cost of Construction – Total Allowance for depreciation. Where "total allowance for depreciation" will include any capital allowance granted prior to April 01, 1981.

The depreciation allowance in respect of qualified building are deducted annually at 5% on the cost of construction until the full cost of construction or acquisition is claimed. No depreciation allowance is due in respect of buildings constructed prior to April 01, 1981, since qualified buildings constructed prior to April 01, 1981 were granted 50% depreciation allowance. The depreciation allowance claimed shall not exceed the cost of the asset. S. 23(i)(e) Proviso (ii).

Construction of dwelling house for occupation by the staff.

An alternative deduction may be obtained in respect of the amount spent by a person in the construction of any house or flat or the cost of purchase of residential accommodation in a registered condominium property for the occupation as a dwelling house by any member of the staff employed by such person provided that:

(i) floor area of such house or flat does not exceed 2000[1] square feet; and

(ii) no allowance for depreciation is deductible in respect of such house or flat. S. 31(2)(1).[2]

---

1. 27 of 1982. 2. 24 of 1980.

The deduction is restricted to one third of the assessable income of that person in the year of assessment in which the expenditure was incurred. There is no carry forward of the balance cost for the future years. The expenditure may however, be spread over a period, as the relief is in respect of the expenditure on the construction of dwelling house for the occupation by any member of the staff including an executive officer.

8. **Depreciation allowance on furniture, utensils or articles for use in Tourist undertakings.** S. 23(1)(d)(i)

An allowance equal to the sum expended in the purchase of any furniture, utensils or articles by any person carrying on an undertaking:

(a) of operating hotel for tourists. S. 16(a).

(b) of operating hotel for tourists by a quoted public company with capital of not less than Rs. 100 million. S. 16A.[1]

(c) an undertaking operating hotel for tourists constructs additional bed rooms. S. 16B.[1]

The amount of depreciation is a once and for all allowance equal to the cost and where such assets are disposed the sale price is treated as profits.

9. **Implements and Equipments of an undertaking to deep-sea or off-shore fishing**: S. 23(1)(d)(ii).

A person is entitled to an allowance equal to the sum expended by any person in the purchase of any implement or equipment for any undertaking of deep-sea or off-shore fishing carried on by that person. The allowance is a once and for all allowance where the implement and equipment on which depreciation allowance is claimed is disposed of the sale price is treated as profits.

10. **Depreciation on vehicles used for travelling.**

Any person carrying on a trade, business, profession or vocation is not entitled to deduct an allowance for depreciation by wear and tear in respect of any vehicles used for travelling. S. 24(2). However, depreciation allowance is permitted to be deducted in respect of:

(a) motor cycle or bicycle used by any employee who is not an executive officer for travelling for the purpose of the employers trade, business, profession or vocation. An executive officer means a director of a company, corporation or an employee in any trade, business, profession or vocation whose monthly emoluments including all allowance are not less than one thousand five hundred rupees. S. 163.[2]

(b) motor coach used for transporting employees to and from their place of work. S. 24(2).[2]

The depreciation allowance due on the straight line method at 25% of the cost of acquisition.

---

1. 40 of 1981. 2. 24 of 1980.

11. **New Omnibuses used for public transport.**

The Commissioner General of Inland Revenue has in a communique prescribed enhanced rate of depreciation allowance of 75% of the cost of omnibuses acquired and used during the period April 01, 1982 to March 31. 1983. The enhanced rate of depreciation will apply only if the following conditions are satisfied:

(a) depreciation is due only to new omnibuses and will not apply to reconditioned buses imported into Sri Lanka;

(b) the omnibuses must be licensed to carry over 15 passengers;

(c) the bus must be used in regular service for public transport;

(d) the bus must be operated with the authority of State Carriage Permit issued by the Ministry of Private Omnibus Transport.

(e) the bus must be engaged on regular services for public transport.

The enhanced depreciation allowance will not be available for the provision of transport service to tourists or provision of occasional tours.

The rate of depreciation allowance prescribed are as follows:

(1) For the period 01.04.1982 to 31.03.1983 – 75%

(2) For the period 01.04.1983 to 31.03.1984 – 25%

12. **Sale or Disposal of Capital assets on which depreciation allowance has been granted.**

The capital asset in relation to a trade, business, profession, or vocation means plant, machinery, fixtures, fittings utensils, articles or equipment used for the purpose of producing the income in such trade, business, profession or vocation and include a building constructed for the purposes of such trade, business, profession, or vocation. S. 23(7)(b). A dsiposal of a capital asset of a person who used such asset in a trade, business, profession or vocation include:

(a) Sale, exchange, or other transfer in any manner whatsoever of such asset;

(b) discard of such asset;

(c) the cessation of the use of such asset in an undertaking carried on by him in ascertaining the profits and income of which an allowance for depreciation could be deducted. S. 23(7)(d).

The amount of the proceeds of disposal of a capital asset shall be:

(a) if the disposal is by sale, the sale price; or

(b) where the disposal is otherwise than by sale, the market value. S. 23(7)(c).

(a) **Disposal of capital assets on which depreciation allowance equal to the full cost of such Capital Assets has been claimed.**

Where a person disposes of a capital asset on which he has claimed depreciation allowance equal to the full cost of such capital asset, the full amount of the sale proceeds will be treated as a receipt of such trade, business, profession or vocation in computing the profits for tax purposes whether the disposal takes place while such trade, business, profession or vocation continues or after its cessation. S. 23(3()(a). This will apply to capital assets on which full cost was allowed as depreciation prior to March 31, 1981 and on capital assets used in tourist undertakings and undertakings for off-shore or deep sea fishing.

(b) **Disposal of Capital Assets on which depreciation allowance granted is less than the cost of acquisition or construction:** S. 23(3)(b).

Where a capital asset on which an allowance for depreciation has been claimed is disposed of either while such trade, business, profession or vocation continues or ceases, the excess of the proceeds of disposal over the difference between the cost of acquisition or the cost of construction of such capital asset and the allowance for depreciation claimed, shall be treated as a profit or loss of such trade, business, profession or vocation. The profit or loss would be:

Profit/Loss = Cost of acquisition – Total allowance for depreciation:

Example I:

Cost of construction June 1980 ...	...	Rs. 50,000
Depreciation allowance claimed – 50%	...	Rs. 25,000
Excess of cost less depreciation allowance	...	Rs. 25,000
Proceeds of Sale	...	Rs. 50,000
Treated as Profits for tax purposes ...	...	Rs. 25,000

Where the sale proceeds are less than the excess of the cost less depreciation, such amount is treated as a loss for tax purposes. Thus in the above example, if the sale price is Rs. 20,000 the loss for tax purposes will be Rs. 5,000.

Example II:

XYZ Ltd. commenced construction of a building for the purpose of the company's business in June 1980 and the amount spent in the construction up to March 31, 1981 was Rs. 150,000. The building was completed in July 1981 and the amount spent in the construction of the building up to July 1981 was Rs. 150,000 bringing the total cost of construction of the building to Rs 300,000. The building was sold on 30th September 1982, for Rs. 400,000.

The amount treated as profits of the trade is computed as follows:

Year of Assessment 1980/81:

Depreciation allowance = Rs. 150,000 @ 50%	...	Rs. 75,000

Year of Assessment 1981/82:

Depreciation allowance claimed = Rs. 150,000 @ 5%		Rs 7,500
Total Depreciation claimed ...	...	Rs 82,500

Computation of Profits/Loss on Disposal of building:

Sale Price	...	Rs. 400,000
Cost	... Rs 300,000	
Less: Depreciation allowance claimed	... Rs. 82,500	217,500
Profit on sale	..	Rs. 182,500

Example III:

Machinery was purchased for Rs. 100,000 on September 15, 1981. Depreciation allowance of 25% on the cost was claimed for year of assessment 1981/82. The machinery was sold for Rs. 60,000 on October 15, 1982.

Computation of Profit/Loss on Disposal for tax purposes: Year of Assessment 1981/82·

Cost of Machinery ...	...	...	Rs.	100,000
Less: Depreciation – 25%	...	...		25,000
Written down value 01.04.1982	...	...	Rs.	75,000
Sale on 15.10.1982 ...	...	...		60,000
Loss on sale for tax purposes for the year of assessment 1982/83 ...	...	...	Rs.	15,000

(c) **Disposal of Capital assets used in undertaking which is wholly or partly exempt from income tax.** S. 23(3((c).

Where a person disposed of capital assets used by him in an undertaking which is wholly or partly exempt from income tax the computation of profit or loss for tax purpose shall be made as follows:

(i) Where the full cost of acquisition has been claimed as depreciation allowance, the full amount of the proceeds of sale shall be treated as profits;

(ii) Where the total amount of the allowance claimed as depreciation is less than the cost of such capital asset the profit or loss for tax purposes is the excess of the proceeds of disposal over the difference between the cost of the capital asset and the depreciation allowance claimed.

(d) **Disposal of capital assets which was only partly used in a trade, business, profession or vocation.** S. 23(3)(d).

There may be circumstances where the capital asset may not be exclusively used in a trade, business, profession or vocation. In such cases adjustment is made by agreement with the Revenue Authorities on the proportion of depreciation allowance which can be allocated for use in trade, business, profession or vocation. When such capital asset is sold, the adjustment in respect of the profit or loss for tax purposes shall be made in the same proportion in which depreciation allowance is claimed.

Example I:

A capital asset was acquired for Rs. 50,000 in June 1980 and it was agreed with the Revenue Authorities that the capital asset is used fifty percent for trade purposes, and Rs. 25,000 being fifty percent of the cost of acquisition was claimed as depreciation allowance in year of assessment 1980/81. The capital asset was sold in October 1982 for Rs. 60,000. The profit on sale for purpose of taxation shall be Rs. 30,000. (50% of Rs. 60,000)

Example II:

In the case of the capital asset in example I above is acquired in October 1981 and sold in November 1982. The Computation of profit or loss is as follows:

Year of Assessment 1981/82:

Cost of Acquisition ...	...	...	Rs.	50,000
Depreciation Allowance 25%	...	...		12,500
Written down value 01.04.82	...	...	Rs.	37,500
Depreciation Allowance – $\frac{1}{2}$ of Rs. 12,500		=	Rs.	6,250

Year of Assessment 1982/83:

Written down value 01.04.1982	...	...	Rs.	37,500
Sale price ...	...	...		60,000
Profit on sale for tax purposes	...	...	Rs	22,500
Profits on sale treated for tax purposes as income: $\frac{1}{2} \times 22,500$ ...	...	=	Rs.	11,250

15. **Disallowance of Depreciation Allowance**. S. 23(5).

No depreciation allowance on capital assets is allowed to a person who lets on hire:

(a) such capital asset to any undertaking the whole or part of the profits and income are exempt from income tax;

(b) such capital asset for the use of any undertaking carried on by the person from whom it was acquired or by any member of the family in partnership with any other person or persons.

Depreciation allowance is also not due to any person if such person uses such capital asset in any undertaking carried on by him in partnership with the person from whom it was acquired or with any member of his family in partnership with any other person or persons. S. 23(5)(b).

The prohibition of deduction does not apply to any person who lets on hire capital assets to an undertaking providing building to a tourist hotel undertaking.

14. **Renewal of Capital Asset**. S. 23(1)(f).

Any sum expended by any person in the renewal of any capital asset employed by such person in producing profits or income can be claimed in computing profits for tax purposes provided no allowance for depreciation is deductible in respect of that asset. S. 23(1)(f).

The cost of renewal of assets are deductible in respect of

(a) implements, tools, utensils, furniture, and fittings; and

(b) buildings.

if these are used to produce profits and income and do not qualify for depreciation allowance prescribed to be deducted in computing profit in accordance with the provisions of the law.

"Renewal as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject matter under discussion." – Bucklay L. J. in *Lurcott v. Wakely and Wheeler* 1 K.B. 905.

Technological changes may sometime make it difficult to identify the new installations as replacements of the old one and on renewal basis there is a risk of losing the allowance if operations are suspended. In the case of *London County Council v. Edwards:* 5 TC 383 tramways operated by horse were converted into electric traction and the renewal allowance was not conceded except for the mileage wholly worn out and due for renewal.

15. **Expenditure on repairs**. S. 23(1)(g).

Any sum expended in effecting repairs to plant, machinery, fixtures, buildings, implements, utensils or articles employed for producing such profits or income can be deducted in computing the profits.

Repair is the expense of putting a persons existing asset into a state of repair which would enable that person to continue to use that asset. The repairs must truly constitute a constantly recurring incident of the continuous employment of the asset which might make it necessary.

Repairs and Renewals.

Difficulty will arise in distinguishing between repairs and renewals. Bucklay L.J. in the case of *Lurcott v. Wakeley and Wheeler:* 1 K.B. 905 made the following distinction.

"Repair always involves renewal; renewal of a part or a subordinate part ......Repair is restoration by renewal or replacement of subsidiary part of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject-matter under discussion."

Repairs would always involve renewal of a subordinate part and every repair is a replacement. For example, if one repairs the roof by putting new tiles instead of the old ones which he throws away; but when one replaces the entirety you are having a new one and it is not repairing the old one.

Repairs necessary at the time of purchase to render the subject matter of purchase serviceable fall to be added to the initial cost of the asset as the capital charge, and cannot be deducted in computing the profits: Law *Shipping v. C.I.R.* 12 TC 621. In this case the vessel was not in a state to pass survey at the time of purchase and could not have been used by the purchaser without effecting the repairs.

A company obtained a lease of premises which was unoccupied for a long time. The company incurred expenditure to reinstate the premises and made repairs, alterations and made the premises suitable for the business. It was held that the expenditure on the accumulated repairs of the premises was capital and therefore not deductible. *Jackson v. Laskers Home Furnishers Ltd.* 37 TC 69.

In the case of the *Odeon Associated Theatres Ltd. v. Jones* 48 TC 257 cost of repairs to four of the company's cinemas which was attributable to wear and tear before they were bought by the company was held to be deductible. The decision on this case was made on the basis that the expenditure on repairs would be treated according to the principles of sound commercial accounting as revenue expenditure and there was no reason to doubt the accuracy of the treatment. Sir John Pennycuik Vice-Chancellor said that one took expenditure as one found it when it was incurred, not spreading artificially over years when it was not incurred. Thus when an asset is brought into use in a trade as an asset which though old was suitable for use in the trade and was for sometime used in that trade, but which has to be reconditioned to a state of repair better than it enjoyed when first brought into use, in such circumstances the expenditure is made with a view to enabling the asset to continue to be used in the trade and to earn the profits of the trade, the expenditure will be an expenditure of revenue and not of capital.

Improvements.

It must be noted that improvement in certain circumstances may qualify for capital allowance. Making any addition to or improvement of any existing building for the purpose of any undertaking operating a hotel for tourists qualify for capital allowance. S. 23(1)(b)(ii). A replacement of a major part may be improvement, say for example replacement of an engine, which would qualify for capital allowance. Cost of any improvements are specifically disallowed in computing profits. S. 24(1)(i).

16. **Repairs expenditure of a company carrying on business of letting commercial buildings.** S. 24(3).

The business of a company include, the letting of commercial premises: S. 163. Therefore, the income derived from letting of commercial premises by a company is income from business and accordingly all outgoings and expenses in carrying on the business of letting commercial buildings can be deducted: S. 24(3). The amount deductible in respect of any sum expended for repairs in the case of a company carrying on the business of letting premises for commercial purposes shall not exceed ten percent of the gross rent receivable by such company for such premises: S. 23(1)(g).

17. **Bad and Doubtful debts incurred in any trade, business, profession, vocation or employment.** S. 23(1)(h).

A sum equal to;

(a) debts which have become bad; and

(b) doubtful debts to the extent that they are estimated to have become bad

during the period for which the profits are ascertained can be deducted in ascertaining the profits or loss of any year of assessment: S. 23(1)(h). Any sum recovered on account of sums which have been previously written off or allowed as bad or doubtful debts shall be treated as receipts of that period of that trade, business, profession, vocation or employment.

The question of whether a debt is bad or not is a question of fact and the onus lies on the tax payer to prove that a debt is bad or is doubtful of recovery. Whether a debt is bad or doubtful of recovery is considered at the end of the accounting period notwithstanding that such bad or doubtful debts were due and payable prior to the commencement of that period. The fact that a debtor is still trading is not a ground to treat a debt as not bad *Dinshaw v. I.T. Commissioners* 50 TLR 527. P.C.

Where money is lent and the loan is not repaid and is irrecoverable, no deduction on account of bad debts can be deducted as in this case the loss is a loss of capital. Where a loan is given in the course of trade or business of money lending the amount if irrecoverable is deductible as bad debt. A banking and money lending business was carried on as a part of the business of a brewery company and it was held that since the entire business was one business and the bad debts in respect of the loans to customers can be deducted: *Reid's Brewery Co. Ltd. v. Male*: 2 TC 279. Loans advanced outside the scope of trade, business, or profession and sum irrecoverable on account of such loans is loss of capital and cannot be deducted as bad debt. *Odhams Press Ltd. v. Cook:* 23 TC 233.

18. **Interest paid or payable.** S. 23(1)(l).

Interest paid or payable in producing profits or income from any source by any person can be deducted in ascertaining the profits and income from such source.

The interest paid or payable which is not directly related to the production of profits or income from any source cannot be deducted in ascertaining the profits from such source. However, such interest is permitted to be deducted in ascertaining the assessable income of that person: S. 29(2) Any deduction of interest paid by a person out of Sri Lanka to a person out of Sri Lanka cannot be claimed as a deduction in arriving at the assessable income: S. 29(2)(a).

19. **Contribution by an employer to an approved provident or pension fund or savings society**: S. 23(1)(j).

Any contribution by an employer to a pension, provident or savings fund or to a provident or savings society, which is approved by the Commissioner General can be deducted in ascertaining the profits of any trade, business, profession or vocation. Initial payments to a pension fund at the inception of a pension scheme for the benefit of the employees, to form the nucleus of the fund was held to be not deductible in computing the profits as the expenditure was of a capital nature: *British Insulated and Helsby Cables Ltd. v. Antherton:* 10 TC 155.

Deductions in respect of contributions are allowed in respect of funds which are approved by the Commissioner General. The Commissioner General grants approval to such fund subject to certain conditions imposed by him, including limitation of the amount of contribution an employer could make in respect of certain category of employees.

20. **Turnover Tax paid.** S. 23(1)(k).[1]

A person is entitled to deduct the Turnover Tax which such person is liable to pay for the period in respect of which profits and income of a trade,

1. 27 of 1982.

business, profession or vocation are ascertained. A deduction on account of turnover tax of any person who is a registered manufacturer under the Turnover Tax Act is the net amount of turnover tax payable by him after taking credit for the turnover tax paid by such person on imports or local purchases, as the case may be.

21. **Expenditure incurred in carrying on any Scientific, Industrial or Agricultural Research.** S. 23(1)(l).

Expenditure incurred by any person in carrying on any Scientific, Industrial or Agricultural research for the development of the trade or business carried on by such person can be deducted in ascertaining profits or income of such person.

22. **Expenditure in respect of agricultural and fishing undertakings.** S. 23(1)(m).

Capital expenditure incurred in respect of undertakings related to agriculture, sericulture, animal husbandry and fishing are permitted to be deducted in ascertaining the profits of such undertakings. The expenditure allowed are:-

(a) **Opening up of land for cultivation or for animal husbandy.**

(i) clearing of land of trees, shrub or undergrowth,
(ii) filling up and draining marshy land,
(iii) terracing,
(iv) construction of access roads and tracks.
(v) construction of fences,
(vi) construction of irrigation channels,
(vii) sinking wells,
(viii) preparation of land for planting, and
(ix) cost of young plants for planting.

(b) **Cultivating the land with plants.**

Expenditure on cultivation of land with plants will include the followings:

(i) Expenditure on maintenance of immature area, and
(ii) expenditure in replanting land with the same or a different plant.

(c) **Purchase of livestock or poultry to be reared on that land.**

Expenditure incurred in the purchase of livestock, or poultry to be reared on that land can be deducted in ascertaining the profits.

(d) **Rearing Inland water fish.**

The following expenditure are allowed in ascertaining the profits of inland fishing undertakings:-

(a) clearing and preparation of any inland waters for rearing of fish;
(b) construction of tanks or ponds;
(c) purchase of fish for rearing

23. **Replanting expenditure.**

Replanting expenditure of a rubber estate has been held as an expenditure incurred as a precautionary measure inseparable from the running of rubber estate on business lines and therefore such expenditure is allowable as an outgoing in the production of income: *Haughton Tea Co. Ltd. v. C.I.T.* 2 CTC 225; in this case the company bought a rubber estate and planted five acres with budded rubber. The Revenue contended that the expenditure in replanting is expenditure incurred to repair the neglect of years and therefore is expenditure on improvement and is of capital nature. Hearne J. commented that –

"It does not appear to me that the expenditure involved in replanting is the substitution of an asset subject to waste for another wasting asset, effects any permanent improvement in an estate and it may be that it is generally regarded as essential revenue expenditure for the purpose of maintaining a certain requisite level of production efficiency."

24. **Travelling expenditure within Sri Lanka.**

Expenditure incurred by any person or his employee in travelling within Sri Lanka in connection with any trade, business, profession or vocation carried on by such person is permitted to be deducted in ascertaining profits subject to the following modifications which prohibit the deduction of:

(a) **Expenditure in travelling.**

- (i) by the person carrying on a trade, business, profession or vocation between his residence and place of business. S. 24(1)(a).
- (ii) by an employee in the employment of a person carrying on any trade, business, profession or vocation between such employee's residence and his place of work. S. 23(1)(n)(ii).

(b) Where the expenses incurred in relation to a vehicle which is owned and maintained by the employer and that vehicle is used partly for the purpose of his trade, business, profession or vocation and partly for the domestic or the private purposes of an executive officer no deduction of such expenses will be allowed unless the employee reimbursed the employer the actual expenses incurred in the use of such vehicle by such employee for his domestic or private purposes. S. 23(1)(n)(i). Where the expenses actually incurred by the employee cannot be ascertained adjustment on account of reimbursement by the employee may be made of a sum which is a reasonable estimate of such expenses, by agreement with the Assessor.

(c) No deduction can be made in respect of an allowance for depreciation for wear and tear or for renewal of any vehicle used for travelling except in respect of motor cycle, scooter or bicycle used by an employee who is not an executive officer.

An executive officer in employment means a director of a company or corporation, or an employee in any trade, business, profession or vocation whose monthly emoluments including all allowances, are not less than one thousand five hundred rupees. S. 163.

1. 24 of 1980

25. Travelling between residence and place of work. S. 24(1)(a).

Expenditure incurred in travelling between residence and place of work is not permitted to be deducted in ascertaining the profits and income of any person carrying on a trade, business, profession, or vocation. The word place of business is used to mean generally the work a man is engaged in whether it is trade or profession. The business or employment cover activities of a person in the nature of trade, business, profession or vocation which are sources of profits.

The expenditure in travelling from the premises in which he resides and has his chambers to the Supreme Court incurred by an advocate are not cost of travelling between residence and place of business. The Chambers of an advocate and courts are the place of business of an advocate and therefore the movements from the place of business to another does not come within the scope of the prohibition: *Rajapakse v. C.I.T.* 1 CTC 27.

Where the business operations are based from the home of a person travelling from the office based at home to place of work is not travelling between residence and place ot work. Thus in the case of a bricklayer who based his business operations from his home, his travelling expenditure between his home and the building sites were held not travelling between residence and place of work. *Horton v. Young:* 47 TC 60.

26. Travelling outside Sri Lanka. S. 24(1)(c).

Expenditure incurred in connection with a trade, business, profession or vocation in travelling outside Sri Lanka are permitted to be deducted in ascertaining the profits and income if such expenditure is incurred solely in connection with:-

(a) the promotion of the export trade of any article or goods; or

(b) the provision of any services for payment in foreign currency.

Any other expenditure, other than those detailed above incurred in travelling oustide Sri Lanka in connection with any trade, business, profession or vocation carried on or exercised in Sri Lanka cannot be deducted in ascertaining the profits. S. 24(1)(c).

An allowance granted by an employer to his employee for travelling, subsistence and lodging in respect of travel by such employee outside Sri Lanka in connection with his employment is exempt from income tax in the hands of the employee: S. 9(1)(j).

27 Expenditure on operation of Motor Coach in transporting employees to and from office.

Any expenditure incurred by any person in operating a motor coach used for the transporting of employees of such person to and from their place of work can be deducted in ascertaining the profits and income of that person. S. 23(1)(p) [1] The person operating a motor coach for use for transport of employees is also entitled to an allowance for depreciation at a fixed rate percent of such motor coach. S. 24(2).[2]

1. 40 of 1981. 2. 24 of 1980

28. **Preliminary Expenses of a Company.**

The expenditure incurred in the formation of a company can be deducted in ascertaining the profits of such company. S. 23(1)(o). The formation expenses of the company include legal fees, cost of printing of the Memorandum and Articles, stamp duty etc.

29. **Profits and income received by a spouse for services rendered.** S. 23(6).

Profits and income received by one spouse for services rendered in any trade, business, profession or vocation carried on or exercised:-

(a) by the other spouse; or

(b) by a partnership of which the other spouse is a partner.

is deemd to be the profits and income of the other spouse. S. 23(6).

Thus the payments for services rendered to the other spouse cannot be deducted in ascertaining the profits of the other spouse in respect of any trade, business, profession or vocation or by any partnership of which the other spouse is a partner. The phrase 'profits and ...... income ...... for services rendered' would refer to salary or remuneration to the other spouse and would not cover a division of profits in a partnership of a husband and wife as partnership by definition is the carrying on of business by any two or more persons in common with a view to profit. The division of profits of a partnership cannot, therefore be considered as payment for services rendered.

30. **Domestic or private expenses.** S. 24(1)(a).

In ascertaining the profits or income from a source only outgoing and expenditure incurred in earning the profits thereor are permitted to be deducted Domestic or private expenses are not expenses incurred in earning profits and are specifically not permitted to be deducted in ascertaining the profits from any source. S. 24(1)(a).

The cost of an operation on the finger of a dance musician was claimed on the ground that operation was undergone to enable the taxpayer to continue to play professionally and enjoy and practice his hobby of playing instruments. It was held that the expenditure is not deductible: *Prince v. Mapp.* 46 TC 169.

In the case Lord Greene said:

"It is impossible to argue that doctors bills represent money wholly and exclusively laid out for the purpose of the trade, business, profession, vocation or employment of the patient. True it is that if you do not get yourself well and so incur expenses to doctors you cannot carry on your trade or profession, and if you do not carry on your trade or profession you will not earn income, and if you do not earn income the Revenue will not earn income, and if you do not earn income the Revenue will not get any tax. The same thing applies for the food you eat and the clothes you wear. But expenses of this kind are not wholly or exclusively laid out for the purpose of the trade."

A shorthand writer sought to deduct medical expenses incurred by him from his professional income on the ground that his illness was due to working in unfavourable conditions; these expenses were held to be not deductible; *Norman v. Goler*, 26 TC 293.

31 **Entertainment expenditure.** S. 24(1)(d) & (e).

Entertainment expenditure incurred by any person or his employee or on behalf of the employer in connection with any trade, business, profession or vocation cannot be deducted in computing the profits. S. 24(1)(d). The prohibition extends to the entertainment allowance paid by the employer to an executive officer in his employment. S. 24(1)(e). The expenditure on entertainment would generally refer to the provision of food and drink and other forms of entertainment provided for business contacts and customers.

32. **Advertising Expenditure.** S. 24(1)(f).

One quarter of the advertising expenditure is not allowed in ascertaining the profits of any trade, business, profession or vocation. While the balance three quarter of the expenses are permitted to be deducted in ascertaining the profits. Expenditure on advertising is generally incurred in attracting custom. Advertising expenditure would be direct expenditure like newspaper advertisment, expenditure on sales promotion, issue of samples to customers etc.

An advertisment for the purpose of recruiting employees is not advertising to attract custom, and would be necessary outgoing of the business in providing labour and can be deducted in ascertaining profits. Advertisement for the purpose of purchasing an asset will form part of the cost acquiring such asset and may not be deductible as a revenue expenditure.

Advertising expenditure outside Sri Lanka.

The full cost of advertising expenditure outside Sri Lanka incurred solely in connection with the export trade of any articles or goods or the provision of any services for payment in foreign currency can be claimed as deduction in computing the profits.

Advertising expenditure of a permanent character.

Certain advertising expenditure may be of a permanent character and would be capital expenditure and cannot be deducted in full. Neon sign boards etc. may come within this category.

Customary gifts by the trade.

Gifts and presentations are sometimes made by the trade during the New Year in the form of calendars, diaries and other materials as a form of advertising campaign. These expenses can be classified as advertising expenses. Business celebrations and publicity campaign is also a form of advertising.

33. **Insurance premia and amounts recoverable under a contract of insurance or indemnity.** S. 24(1)(j).

Where an insurance policy is contracted in respect of fire, burglary, civil commotion, loss of profits, loss of market etc. the insurance premia will be expenses incurred in the production of income and can be claimed as a deduction in ascertaining the profits of any trade, business, profession or vocation. Where any sum paid as insurance premium is allowable as an expense incurred in the production of income from any trade, business, profession or vocation sums realised shall be deemed to be receipt of that trade, business, profession or vocation and the profits arising out of such receipt is computed in a specified manner, depending on the nature of the asset or the event against which the insurance has been taken. S. 89.[1]

Where any sum is realised from a contract of insurance or indemnity, the amounts realised are treated as follows for tax purposes:

(a) **Where the sum realised is in respect of stock in trade or loss of profits.** S. 89(a).[1]

The full amount realised on the insurance for loss of stock in trade or loss of profits will be treated as a receipt from that trade, business, profession or vocation in making up the profits or loss of that trade, business, profession or vocation.

(b) **Where the sum realised is in respect of any capital asset on which depreciation allowance has been claimed.** S. 89(b).[1]

The amount realised under an insurance in respect of any capital asset on which depreciation allowance has been claimed is treated as a sum realised on the disposal of such capital asset and the profits or loss is computed as follows:

(i) Where the total amount equal to the cost of acquisition of such capital asset has been allowed, as an allowance for depreciation, the full amount realised under the contract of insurance will be treated as profits.

(ii) Where the total of the allowances for depreciation claimed in respect of a capital asset is less than the cost of acquisition of such asset, the excess of the sum realised under the contract of insurance over the difference between the cost of acquisition and the total depreciation allowances granted is treated as a profit or loss as the case may be.

(c) **Where the sum realised is in respect of capital asset in respect of which depreciation has not been granted.** S. 89(c).

Where any sum is received in respect of any insurance of any asset on which depreciation allowance has not been granted the amount realised is a capital receipt and will not form part of the receipt of any trade, business, profession or vocation. Such a sum realised on a contract of insurance is treated as an amount realised from the change of ownership of property and a capital gain or a capital loss may arise for the tax purposes. Where the amount realised exceeds the cost and allowable expenses, a capital gain will arise and where the sum realised is less than the cost of acquisition and allowable deduction capital loss may arise.

A payment received under a contract of insurance for loss of trading was held to be a trading receipt; *Gliksten & Sons Ltd. v. Green.* 14 TC 381.

1. 24 of 1980.

Money received under an insurance against loss of profits was held to be a revenue receipt and was assessable to income tax: *Rex v. British Col. Fir & Cedar Co. Ltd.* 1932 AC 441 (Privy Council). A trading company insured the life of an employee, whose services were regarded as valuable, and the sum received on his death was held to be a revenue receipt. *I.R. v. William's Executors:* 26 TC 23.

A shipping company which had placed orders for new ships, took out policies of insurance against late deliveries of the ships and received sums of money under that contract of insurance. It was held that the monies received were capital receipts and should be treated in the same way as price payable for the ships had been reduced by late delivery: *Crabb v. Blue Star Line Ltd.* 39 TC 482.

Deduction on account of losses where such losses are covered under a contract of insurance. S. 24(1)(g).

Where any sum paid as insurance premia on any contract of insurance is allowed as a deduction in ascertaining the profits of any trade, business, profession or vocation, any sum received under the contract of insurance is treated as income. In such cases the losses incurred are deducted while the sum recovered is treated as income.

Where the sum paid as insurance premia cannot be deducted as an outgoing in ascertaining the profits of any trade, business, profession or vocation, any sum received under the contract of insurance is not treated as income. In such cases, any losses incurred are not permitted to be deducted while the sum recovered under the contract of insurance is not treated as a receipt of that trade, business, profession or vocation.

34. **Rent of or expenses of any premises or part of premises not occupied or used for the purpose of producing income.**

In ascertaining the profits of any person from any source the rent of or any expenses incurred in connection with any premises not occupied or used for the purpose of producing such profits is not permitted to be deducted. S. 24(1)(k).

Where only part of the premises are occupied for the purpose of any trade, business, profession or vocation only the rent of or expenses relating to that part can be deducted in ascertaining the profits. The rent of or expenses in such circumstances can be apportioned in proportion to the floor area occupied for such use.

In respect of premises owned and occupied for the purpose of any trade, business, profession or vocation no deduction can be made of any sum as a notional rent for such premises. Deduction on account of rates and repairs of such premises can be deducted in ascertaining the profits.

Where part of the premises are sub-let the rent and expenses should be apportioned and the rent and expenses applicable to the part occupied for the purpose of producing income can be claimed.

The rent income received from subletting is assessable to tax classified as income arising from the source rent and accordingly in computing the income from such rent the deductions permitted are the rates and repairs applicable to the part of premises sub-let.

35. **Taxes paid.** S. 24(1).

In ascertaining the profits of any person any amount paid or payable in respect of the following taxes and levys are not permitted to be deducted:-

(i) Income Tax, Super Tax or Sur Tax or any other tax of similar character in any country with which an agreement for the avoidance of double taxation is in force. Where the tax payable in any other country exceeds the amount of the tax credit available under the Double Tax Agreement such excess may be deducted.

(ii) Sri Lanka Income Tax or Commonwealth Tax.

(iii) any prescribed tax or levy.

Tax payments are normally payments out of profits and do not rank as expenses incurred in earning profits and cannot therefore be deducted in computing profits for tax purposes: *Allen v. Farquharson Bros.* 17 TC 59; *I.R. v. Dowdall O'Mahoney & Co. Ltd.* 33 TC 259.

36. **Capital Expenditure.** S. 24(1)(j).

Whether a particular series of payments is capital expenditure is *prima facie* a question of fact and will depend on the origin, nature and the circumstances of the payments. There are no infallible tests to determine whether a sum is of capital or revenue nature; one has to look to all the circumstances and reach a conclusion according to their general tenor and combined effect.

"Some cases lie on the border between the two, and this border is not a line clearly marked out. It is a blurred and undefined area in which anyone can get lost. Different minds may come to different conclusions with equal propriety. It is like the border between the day and the night, or between red and orange. Everyone can tell the difference except in marginal cases and then everyone is in doubt. Each can come down either way". Lord Denning in *Heather v. P. E. Consulting Group Ltd.* 48 TC 293.

What is capital expenditure?

Lord Dunedin observed in *Vallambrosa Rubber Co. v. Farmer,* 5 TC 529 that in a 'rough way' it was not a bad criterion of what is capital expenditure as against what is income expenditure, to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year. Recurrence of expenditure does not make an expenditure a revenue item if the nature of the business or other evidence show that an item of expenditure is of capital nature. Thus in *Eastman v. Shaw,* 14 TC 218, the company substituted a new butchers shop for an old one according to the needs of the business, when shifting from one town to another, the expenditure was held to be capital expenditure and therefore not deductible in computing the profits.

"They substitute one shop, which however short a time it lasts, is permanent in its nature, for another shop, which for however short a time it has lasted, has also been in its nature of a permanent character"...... Justice Rowlatt.

Definition of Capital Expenditure

> "When an expenditure is made not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think there is very good reason (in the absence of any other special circumstances leading to the opposite conclusion) for treating such expenditure as properly attributable, not to revenue, but to capital".

Lord Cave in the case of *British Insulated and Helsby Cables v. Atherton,* 10 TC 155. The expenditure which was held to be a capital outlay in the *Atherton case* took the form of a payment made at the inception of a pension scheme for the benefit of the company's staff, as an outright payment intended to form the nucleus of the pension fund. The advantage that resulted from the payment was the securing of a contented and efficient staff.

The fact that an asset is of a short duration does not prevent an asset from being regarded as capital asset. *John Smith and Son v. Moore,* 12 TC 261. In the case of *Theobold v. C.I.T.,* 1 CTC 186, it was held tha the cost of temporary sheds erected on the leasehold land to house the drying ovens of a business of making papain were expenditure of a capital nature. The nature of the business was that they have to move from one site to another on the expiration of the lease frequently abandoning the structures. 'In this case the applicant obtains the benefit of the structure for the full period for which the land can be regarded economically exploitable for the making of papain: and that period of time is, in my opinion a substantial period, or to adopt the language of Romer L.J., the applicant has no intention of removing or abandoning these structures "at a comparatively early date" – Keuneman J.

A further attempt at distinguishing between capital and revenue expenditure was made by Megarry J. in the case of *Pilt v. Castle Hill Warehousing Co. Ltd.,* 49 TC 638. Where he held that the expenses incurred in replacing one right of access to a warehouse with another as capital expenditure. He said:

> "It seems to me that these authorities established that in determining whether expenditure is incurred on revenue account or on capital account, one must consider at least three elements. First, what is the nature of the payment" Is there a single non-recurrent lump sum paid once-for-all, on the one hand, or are there to be current payments made, for example, for periods commensurate with the payments" Second, what is to be obtained for the payment" Is it some asset with lasting or enduring qualities, or is it merely ephemeral, or, indeed, something which cannot be described as an asset, whether tangible or intangible" Third, in what manner is what is obtained to be used, relied on or enjoyed" Will it have a quality of recurrence which will point to an income nature, as by providing a flow of orders for goods, or will it bear a static aspect which points to a capital nature" In considering all these elements, and in looking at the case as a whole, it is the practical and busines s point of view that counts for more than the juristic classification of the legal rights employed or exhausted in the process."

An expenditure incurred in order to gain advatnage by obtaining release from onerous mining contracts was held to be capital expenditure, *Mallet v. Staveley Coal & Iron Co. Ltd.,*. 13 TC 772. The payment in this case was made for the purpose of modifying the conditions of an existing contract so as to make the resultant terms more advantageous for the enduring benefit of the trade. Again the case of *Associated Portland Cement Co. v. Kerr,* 27 TC 103, a sum of money was paid to a retiring director in consideration of a restrictive convenant not to compete with the company. This was held to be an expenditure of a capital nature. The payment to the director was an expenditure made once and for all to bring into existence an advantage for the enduring benefit of the trade; the advantage was the addition to the goodwill by buying off two potential competitors.

The advantage or the benefit paid for should endure in the way that fixed capital endures, "not......in the sense that for a good many years it relieves you of a revenue payment" to make a payment capital in nature. Where the advantage gained, though consisting in the termination of onerous contract, was merely a change of business method in the saving of working expenses, the payment was held to have been made on revenue account: *Anglo-Persian Oil Co. v. Dale,* 27 TC 103. The payment was for the cancelling of an agency agreement so that the company could itself undertake the management of the business. This payment neither enlarged the area of its operations nor improved its goodwill, nor embarked upon a new enterprise; it merely effected a change in its business methods and internal organisation, leaving its fixed capital untouched.

A lump sum of payment to purchase an annuity equal in amount to pensions payable to former employees was held to be revenue expenditure: *Hancock v. General Reversionary & Investment Co.,* 7 TC 358. The lump sum payment here was made in replacement of an existing revenue liability for it merely compressed into one year a charge which was in its nature recurrent. It was the pension in another form; it is actuarially equivalent in value and it is indentical in character and was a payment to meet a continuing demand which by itself is ordinary business expenses. The same reasoning was followed in the case of *National Mutual Life Association v. C.I.T.* 1 CTC 342. In this case the company was liable to pay pensions to its employees in accordance with a staff superannuation scheme. It created a Staff Superannuation Trust Fund by deed and vested the fund with the Trustee, and paid an initial contribution of £150,000 being the amount found necessary to meet the obligation under the deed. It was held that this was deductible expense in that there was an existing liability on the part of the company to pay old age pensions to its employees and that the company provided a lump sum in order to prevent annual sums having to be paid later and to be able to fulfil its promises to its employees and therefore this payment is an ordinary business expense.

A lump sum payment by the employers to purchase annuities payable to themselves, equivalent in amount to the voluntary pensions payable to the former employees was held to be an expenditure of a capital nature. The reason for the decision here is that the company got rid of the liability to pay an annual sum and got an asset, the company has got an insurance company which will in future not extinguish the liability but have got the command of the policy to the extent that they are entitled to get their capital money: *Morgan Crucible v. C.I.R.* 17 TC 311.

Payment for termination of agency contracts.

Payments made for the termination of agency agreements can be either capital payments or revenue payment. Whether a payment is of capital or revenue nature will involve an enquiry into whether the cancelled agreements were ordinary commercial contracts made in the course of the trade or whether they were affecting the whole structure of the profit making apparatus. The distinction may be formulated as whether the contracts are:-

(i) Contracts made by the trader which are merely directed to result in trading profits being made, or

(ii) Contracts made by the trader which were directed to regulate the conditions under which he is to carry on his trade.

Thus in the case of *Van den Berghs Ltd. v. Clark,* 19 TC 390, a payment made for the cancellation of an agreement directed to the creation of joint arrangements as to prices, limitations of areas of supply, restriction on any pooling arrangements and to share profits as held to be a capital receipt. The agreements cancelled were not ordinary commercial contracts and affected the whole structure of the profit making apparatus.

The cancelled agreements related to the whole structure of the appellants' profit-making apparatus. They regulated the appellants activities, defined what they might and what they might not do, and affected the whole conduct of their business. I have difficulty in seeing how money laid out to secure, or money received for the cancellation of, so fundamental an organisation of a trader's activities can be regarded as an income disbursement or an income receipt." – Lord Macmillan in *Van Den Berghs Ltd. v. Clark,* 19 TC 390.

Every payment or a receipt for cancellation of a contract cannot be regarded as capital; it depends upon all circumstances of the case. In the case of *Kelsall Parsons & Co. v. C.I.R.* 21 TC 608, one of the agency agreements was terminated in consideration of a payment of £1,500. This was held to be a revenue receipt. The company in this case carried on business as selling agents of various manufacturers and entered into a number of agency agreements for that purpose. It was a normal incident of the assessee's business that the agency agreements might be modified, altered or discharged from time to time. Such contracts were incidental to the normal course of their business which was to obtain as many contracts of this kind as they could, their profits were gained by rendering service in fulfilment of such contracts. The payment received in this case did not represent the whole of the capital asset of the company.

In the case of *Barr, Crombie & Co. Ltd. v. C.I.R.* 26 TC 406 the company's business consisted almost entirely of the agency which it carried on as managers of the shipping company and came to a standstill on the liquidation of the other company. A payment representing the remuneration of the company for the unexpired period of the agreement was held to be a capital sum, being the price of the extinction of the company's only asset, and the remuneration contemplated in the agreement was used as a measure of the sum payable.

Where you have a payment for the loss of the contract upon which the whole trade of the company has been built, where the expected profits of the contracts are used to measure the loss of them for a period of the future years, and where in consequence of the loss of the company's structure and character are greatly affected, the payment seem to me to be beyond doubt a capital payment." – Lord Normand.

The cost of acquisition of unexpired contracts were held to be not deductible in computing the profits; *John Smith & Sons v. Moore,* 12 TC 266. In this case a testator bequeathed his coal merchant's business to his son at a valuation, and the business was valued at an amount which included the price of some unexpired contracts with the colliery owners for the supply of coal. It was held that the sum representing the price of the contracts was a capital sum, which has been paid as part of the cost of acquiring the whole business.

In the case of *Golden Horse Shoe Co. v. Thurgood,* 18 TC 280, the company was incorporated to acquire the rights of another company in certain dumps of ore from which gold had been extracted. The appellant company's sole business was the extracting and selling the gold which remained in the tailings dumps. The company claimed that it was entitled to deduct the purchase price in computing the profit on the ground that the payment made was not to purchase a capital asset but for the purchase of stock, was upheld by the courts. In contrast, in the case of *Huges v. British Burmah Petroleum Co.* 17 TC 286, an oil producing company paid a sum for unwon oil in certain wells. It was held that this sum was of capital nature, and did not constitute payments for stock and will not be admissible deduction in computing the profits.

A fruit grower bought the freehold of a cherry orchard inclusive of the years crop, which was nearly ripe for plucking. He claimed a portion of the purchase price as the sum paid for the cherries which were picked and sold by him after the purchase, as the cherries were *fructus industriales* and not *fructus naturales* and therefore did not form part of the land bought. It was held that no sum could be deductible as the whole of the sum paid was for the purchase of land as capital asset including the fruits: *C.I.R. v. Pilcher* 31 TC 314. The court observed that if Pilcher had bought the fruit and the land separately different consideration would apply and the cost of cherries would have been deductible.

The contrast between fixed and circulating capital provides a satisfactory test as to the nature of the particular payment. The payment will be found to be an outgoing not of capital but of revenue if it relates to circulating capital.

"Land may in certain circumstances be circulating capital. A chattel or a chose in action may be fixed capital. The determining factor is the nature of the trade in which the asset is employed. The land upon which a manufacturer carries on his business is part of his fixed capital. The land which a dealer in real estate carries on his business is part of his circulating capital. The machinery with which a manufacturer makes the article that he sells is part of his fixed capital. The machinery that a dealer in machinery buys and sells is part of his cirulating capital, as is the coal that a coal merchant buys and sells in the course of his trade. So too is the coal that a manufacturer of gas buys from which he extracts his gas." Lord Justice Romer in *Golden Horse Shoe Co. v. Thurgood.* 18 TC 280.

The relative nature of fixed and circulating capital is, "Circulating capital is capital which is turned over, and in the process of being turned over yields profit or loss. Fixed capital is not involved directly in that process and remains unaffected by it." Lord Macmillan in *Van Den Berghs Ltd. v. Clark,* 19 TC 390.

In the case of *Haughton Tea Company v. C.I.T.,* 1 CTC 198, the Revenue contended that replanting expenses is of a capital nature as it represented an expenditure to make up to the owner the deterioration caused by the previous owner and relied on the Law Shipping case decision. The Court held that the expenditure is properly deductible and that replanting expenditure was incurred not to repair the neglect of years so as to enable the estate to yield a return, but as a precautionary measure, inseparable from the running of a rubber estate on business lines. It was also held obiter that the expenditure involved in replanting is the substitution of an asset subject to waste for another wasting asset, does not effect any improvement in an estate and that it may be regarded as an essential expenditure for the purpose of maintaining a certain requisite level of productive efficiency.

Attention must be paid to the receipt or the payment itself; the fact that the consideration for it is of a revenue or capital nature is not determinative. An item of income such as an annuity may be purchased from capital or the right to future payments of income may be commuted from a capital sum. In the case of *Nilgiriya v. C.I.T.* 3 CTC 45, a surviving partner bought the share of goodwill of the deceased partner from the widow at an agreed valuation. The agreement provided for payment of a fixed monthly instalment, which sum he claimed to deduct in computing his profits as an annuity or charge. It was held that the payment was of a capital nature and therefore cannot be deducted in computing the profits. A medical practitioner bought a business of a dispensary making a part payment of Rs. 6,000 and agreed to pay thirty-six percent of the gross monthly income of two years, and sought to deduct this payment in computing his profits. It was held that the nature of the payment was in reality part of the purchase price of the business and was therefore of capital nature, which sum cannot be deducted in computing the profits. *C.I.T. v. De Silva,* 3 TC 124; *I.R. v. Ramsay;* 20 TC 79.

The distribution between capital and revenue expenditure discussed in the foregoing paragraphs gives valuable guide in deciding this vexed question. The following quotation by Dixon J. in *Sun Newspapers Ltd. v. Federal Commissioner of Taxation,* 61 C.L.R. 337 was quoted with approval in the case of *Strick v. Regent Oil Co. Ltd.,* 43 TC 1.

"There are ...... three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for the periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment."

37. **Distinction between Capital and revenue receipt.**

Income tax is levied only on income and therefore in the computation of income all capital receipts should be excluded in computing the profits from trade, business, profession or vocation. Any capital profits may be assessed as capital gains if such profits are deemed to be income for purpose of liability for income tax. S. 3(h).

The problem of distinguishing between capital and revenue receipt may be illustrated from the judgment of Lord Mac Dermott in the case of *Harry Ferguson (Motors) Ltd. v. I.R.C.* 33 TC 15:

"There is so far as we are aware no single infallible test for setting the vexed question whether a receipt is of an income or a capital nature. Each case must depend upon its particular facts and what may have weight in one set of circumstances may have little weight in another. Thus the use of the words "Income" and "Capital" is not necessarily conclusive; what is paid out of profits may not always be income; and what is paid as consideration for a capital asset may on occasion be received as income. One has to look to all the relevant circumstances and reach a conclusion according to their general tenor and combined effect."

The test for distinguishing between revenue and capital receipt may require contrast of transactions relating to fixed and circulating capital. This distinction has been clearly made in the case of *John Smith & Son v. Moore,* 12 TC 266, although the decision was whether the payment was a trading expenditure, by Lord Haldane:

"The appellant of course made profit with circulating capital by buying coal under the contracts ...... and reselling it for more, but he was able to do this because he had acquired among other assets of his business, including the goodwill, the contracts in question. It was not by selling these contracts, of limited duration though they were it was not by parting with them to other master, but by retaining them, that he was able to employ his circulating capital in buying under them. I am accordingly of opinion that although they may have been of short duration, they were nevertheless part of fixed capital."

Decided cases distinguishing between capital and revenue receipts are discussed below:

Sale of business Assets.

When profit accrues from sale of business assets the question will arise whether the profit is capital profits chargeable with capital gains tax or trade profit. Where the sale is of capital investment or a capital asset the proceeds are accretion to capital. The demarcation is:

"...... the question to be determined being – is the sum of gain that has been made a mere enhancement of value by realising a security or is it gain made in the operation of business in carrying out a scheme of profit making."

Lord Justice Clerk, in the case of *Californian Copper Syndicate v. Harris*, 5 TC 159.

Where the transactions are in the taxpayer's ordinary line of business, there will be no difficulty in finding that the sum received will be on revenue account. Where a capital asset is sold with a stipulation providing for the receipt of commission of a percentage of future sales these were held to be revenue receipts: *Orchard Wine Supply Co. v. Laynes*, 33 TC 97. In this case a partnership business of wine and spirit merchants sold a secret formula, trade mark and the goodwill relating to a particular type of liquor and the term of the sale entitled them to commission on future sales.

A person may have capital and revenue receipts. Thus in the case of *West v. Phillips*, 38 TC 203, where a builder built some houses to hold as an investment and some for resale, the sale of houses held by him for reasons unconnected with his trade was held to be outside the ambit of his trade and the receipts were capital receipts not giving rise to a trading profit.

Sterilisation of capital asset.

Compensation received from a railway company for not working the bed of clay which would have caused a railway line to subside was held to be capital receipt as the payment did not arise or accrue by or through any of the company's trade or business. This is a sum of money paid to prevent the Fire Clay company obtaining the full benefit of the capital value of that part of the mine which they were prevented from working by the railway company. The amount of the compensation award was the estimate of the capitalised amount of the profits which the company had been deprived of: *Glenboig Union Fire Clay Co. v. I.R.C.* 12 TC 427.

A sum received as damages for restrictive convenants imposed on a trade is capital receipt. If a trader or a professional man for consideration agrees to give up his trade or profession for the rest of his life, the sum received will be capital: *Higgs v. Oliver*, 33 TC 136.

In *Shadbolt v. Salmon Estates Ltd.*, 25 TC 52, a lump sum paid in consideration of an agreement between a company building and selling houses and a land owning body for withdrawal of certain plots of land from the scheme under which the company had acquired the right to build in the course of its trade was held to be revenue receipt and not a compensation for loss of capital. The right to build on the 'lots' was a trading asset of the company and the company in this case was carrying on the business of building and selling houses

Compensation for cancellation of contracts.

In *Short Brothers Ltd. v. C.I.R.* 12 TC 955, compensation paid to a ship building company in respect of the cancellation of a contract to build two ships was held to be a trade profit as the compensation was received in the ordinary course of the company's trade. This was held to be a sum received in order that as a matter of business, the liability and responsibility under the contracts should be terminated and the business could be free to engage in others.

A finding that the receipt will be a capital sum is due where it can be established that the contract related to the entire structure of the profit making apparatus. It must be proved that the whole of the structure of the business was built on the contract itself so that the cancellation of such contracts will affect the entire structure and character of the business. In the case of *Barr Crombie & Co. v. C.I.R.*: 26 TC 406, the structure of a ship managing company and the character of the business were held to have been radically altered as a result of the shipping company going into liquidation before an agreement under which the appellant company managed the shipping business of the company had expired. The company's business consisted almost entirely of managing ships for the particular company under agreement, almost 88.23% of its trade receipts from that company. The sum received was held to be capital as virtually the whole of the agreement was surrendered and practically nothing remained of the company's business.

In contrast in the case of *Wiseburg v. Domville,* 36 TC 527, the taxpayer had only two agency agreements, one of which provided 60% of its trading profits. It was held that the loss of that contract did not damage the business structure sufficiently to warrant the receipt being regarded as capital. Damages were paid by auditors for their negligence in not making certain inquiries which would have revealed certain misappropriation by employees. The amount of damages received from the auditors was held to be a revenue receipt on the reasoning:

> "If ...... would be absurd to say while sums ...... fraudulently appropriated were to be regarded as an outgoing and therefore as a deduction from profits, the recoupment which they themselves made was not to be brought in." – Finlay J. in the case of *Gray v. Lord Penryhn,* 21 TC 252.

Damages or compensation received to cover trading losses are themselves income to be brought into the computation of profits. The principle has been clearly stated in the case of *London and Thames Haven Oil Wharves Ltd. v. Atwool,* 43 TC 491, by Diplock J.

> "Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so received, the compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received instead of the compensation. The rule is applicable whatever the source of the legal right to recover the compensation. It may arise from a primary obligation under a contract, such as a contract of insurance; from a secondary obligation arising out of non-performance of a contract, such as a right to damages, either liquidated, as under the demurrage clauses in a charterparty, or liquidated; from an obligation; or in any other way in which legal obligation arise."

38. Payments made out of profits.

A payment made out of profits after they have been earned cannot be considered as an outgoing incurred in the production of income. Expenses incurred in ascertaining the amount of the profits chargeable to income tax cannot be considered as an outgoing incurred in the production of income: *Smith's Potato Estates Ltd. v. Holland;* 30 TC 267. In this case, the legal cost expended in connection with profits tax appeal was held to be not deductible. The basis of the decision was:-

"Neither the cost of ascertaining taxable profits nor the cost of disputing with the Revenue Authorities is money spent to enable the trader to earn profit in his trade. What profit he has earned he has earned before even the voice or the tax gatherer is heard. He would have earned no more and no less if there was no such thing as income tax." – Lord Simonds, in the above case.

The Revenue practice is to allow audit and accountancy expenses incurred for the purpose of ascertaining the profits chargeable with tax and can therefore be deducted in computing the liability. Expenses of appeal against assessment cannot be deducted in the computation.

39. Legal Expenses.

Legal expenses incurred in the course of any trading activity is deductible in computing the profits. The litigation expenses of a money lender incurred in connection with the recovery of the loans can be deducted as being an amount incurred in the production of income. However, any legal expenditure incurred in recovering money loaned by persons who are not carrying on the business of money lending is not deductible.

Legal expenditure incurred in defending the title to any property will be revenue expenditure while legal expenditure in the purchase of any property is capital expenditure which cannot be deducted in computing profits. Expenses incurred in taking a bank overdraft for the normal financing of a business will be allowable while expenses in connection with a loan to purchase a fixed asset is not allowable as a deduction. Legal expenditure in defending the title to a capital asset was held to be a revenue disbursement: *Sothern v. Borax Consolidated Ltd.,* 25 TC 597.

The test for the deductibility of legal expenditure is whether the expense was incurred in the character of a trader and the liability fell on him as a trader, and whether the transaction in respect of which the proceedings were taken arose out of and was incidental to the taxpayers business.

Legal expenses incurred by the proprietor of a business over litigation with other persons as to their respective rights to share in the ownership of the business cannot be charged against the profits of the business itself: *Davith Appuhamy v. C.I.R.* 2 CTC 180.

40. Fines and Penalties.

A breach of any law or regulation may result in incurring of penalties and fines and such sums cannot be deducted in computing the profit of the business: *C.I.R. v. Alexander Von Glen,* 12 TC 232. Such fines do not come within the concept of expenses incurred in the production of income and therefore cannot be deducted in computing profits. Business turnover tax penalty and income tax penalty levied for the late payment of these taxes cannot be deducted. Any fines paid for the infringement of customs regulations cannot be deducted in computing profits.

41. Misappropriation by Employees.

Misappropriation by subordinate employees can be deducted while misappropriations by a director of a company cannot be deducted in computing profits: *Banford v. A. T. C. Advertising,* 48 TC 359.

42. Subscription and Donations.

Subscription and donations are disbursements of profits and therefore cannot be deducted in computing the profits. Subscriptions to trade associations are normally allowable in computing profits. Donations to approved charities qualify for relief (S. 31) but cannot be deducted in computing profits.

43. Stock Valuation.

It is a well established principle of accountancy practice to value stock in hand at the end of an accouting period at cost or market value whichever is lower to ascertain the profits of a merchant or manufacturer's business. There is, however, no statutory provision which gives any guidance with regard to the basis to be adopted in valuing stock for the purpose of computing the profits for income tax purposes. The reason for the valuation of stock has been clearly stated by Lord Russel in the case of *B. S. C. Footwear Ltd. v. Ridgeway,* 47 TC 495.

"In my view the accepted practice of entering stock-in-hand at cost at the terminal date of the first period and the opening date of the second period arises from the fact that the expenditure has not contributed anything directly to the figures of gross profit in the first period. It is unusual expenditure to be carried forward into the second period in which it is estimated that it will contribute to the gross profit of the second period that is if it is estimated that it will sell below cost the shortfall is to be regarded in the course of stock valuation as irrecoverable and may properly be treated as a loss incurred in the first period. This I believe to be the basis of the principle that for tax purposes market value, if below cost, may be taken as the value of stock in hand. The principle relates to loss of all gross profit and more and not to diminution."

The valuation of stock at the end of an accounting period on the basis of cost or market value whichever is lower has been accepted as a sound commercial practice by the Courts: *Briggs Newman & Co. v. C.I.R.* 12 TC 119. In *C.I.R. v. Cock Russel & Co. Ltd.* 29 TC 387, it was held that in selecting the lower of the cost or market value it is not necessary to compare overall cost with overall market value, but the taxpayer could "pick and choose" making comparision item by item.

Cost.

The cost of stock generally covers all expenditure on materials direct labour and a proportion of overhead expenditure directly related to production of that particular stock of goods. In valuing stock at cost the method adopted must be consistently followed and any change will not be permitted. In the case of *Duple Motor Bodies Ltd. v. Ostime,* 39 TC 537, the company had consistently based its valuation on Direct Method and the House of Lords refused to allow the contention of the Revenue that the value of stock must be based on the on-cost method including a portion in indirect Cost (overheads) in valuing stock in trade of custom-built motor bodies each unit of output necessarily differing from the other.

Market Value

Market value means the price at which the stock would fetch on that date in an open market. The determination of the market value will have to be based on the assumption of a sale price between a willing seller and a willing buyer bargaining on equal terms and at arms length, so that the price received or given reflect a fair and true price for the stock. In the context of a valuation at lower of cost or market value would mean the price at which the stock could be expected to be sold in the traders usual market and not by reference to any other market that may exist for that commodity. In the case of *B. S. Footwear Ltd. v. Ridgeway*, 47 TC 495, it was held that in the context of the lower of the cost or market value, the expression market value meant the price at which stock could be expected to be sold in the trader's usual market, which was the retail market and while that market existed there was no justification for turning to any other market.

> "May be it would be appropriate that for tax purposes any of several methods in this connection of showing a years profits or gains of a trade should be acceptable, as may be the case when ascertaining the proper cost and work-in-progress. But it seems to me that for tax purposes the valuation of stock in hand at market value, if lower than cost, has crystallized in a retail trade as the price fairly to be expected as the retail sale price of the goods in due course, assuming that, as here, a retail sale is still to be expected." – Russel J

Basis of Stock Valuation when transfer of stock takes place.

Problems arise in dealing with transfer of stock otherwise than in the course of trade. In this connection comments of Viscount Simon in the case of *Sharkey v Wernher*, 36 TC 275 give the basic principles to be applied in such circumstances:

> "When it has been admitted or determined that an article forms part of the stock in trade of the trader, and that upon his parting with it, it no longer forms part of his stock in trade, some sum must appear in his trading accounts as having been received in respect of it, the only logical way to treat it is to regard it as having been disposed of by way of trade. If so, I see no reason for ascribing to it any other sum than that which he would normally have received for it in the due course of trade, that is to say the market value."

The basis of valuing stock at market value will not apply to a *bona fide* trading transaction in which the price which has been negotiated is a fair and proper price. In such cases the taxpayer will be entitled to deduct cost price of the asset irrespective of the market value; *Gradock v. Zevo Finance Co. Ltd.* 27 TC 267: *Julius Benedict Ltd. v. C.I.R.* 27 TC 44. Where the transactions are not *bona fide* trading transactions and is not at arms length, the market value will be applied. Where the price paid is a price negotiated as a fair and proper price the cost actually paid will be adopted: *Jaegilden (West Haff) Ltd. v. C.I.R.* 45 TC 685.

Where there is exchange of trading stock by way of barter, in the course of trade, such exchange will amount to a realisation of trading stock. In such circumstances the correct figure to be adopted will be the market price for the trader transfering the stock and for the trader receiving the stock on such transfer.

44. **Annuity Ground Rent or Royalty.** S. 24(1)(m).

In ascertaining the profits or income of any person from any source no deduction is permitted in respect of any annuity, ground rent, or royalty paid by such person. However, such payments are deductible from the statutory income in ascertaining the assessable income provided that such payments are not payable by a person out of Sri Lanka to another person out of Sri Lanka. S. 29(2)(a). Where an annuity is payable by any person for a period not exceeding six years no deductions are allowed in respect of any sum unless such payment was for valuable and sufficient consideration. S. 29 (2)(v).[1]

45. **Assessor to disregard certain transactions and dispositions as artificial or fictitious.** S. 91.

Where an Assessor is of opinion that any transaction which reduces or would have the effect of reducing the amount of the tax payable by any person is artificial or fictitious or that any disposition is not given effect to, he may disregard any such transaction or disposition and the parties to the transaction or disposition shall be assessable accordingly. A disposition includes any trust, grant, covenant, agreement or arrangement.

This is an anti-avoidance provision which gives the Assessor the right of disregarding any transaction which although having legal basis, if the assessor is of opinion that –

(a) the transaction has the effect of reducing the amount of tax payable is artificial or fictious; or

(b) that any disposition is not in fact given effect to.

Whether a transaction can be properly described as artificial or fictitious will depend upon the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out.

The interpretation of the provisions of this section can be found in the Privy Council judgment delivered by Lord Diplock in the case of the *Trustees of Seramco Ltd. Superannuation Fund v. Commissioner of Income Tax:* Privy Council Appeal Case No. 12 of 1974 from the Court of Appeal in Jamaica. The provisions of the Jamaican Law is almost similar to our section 91.

The meaning of the word 'artificial or fictitious' as given by Lord Diplock:

" 'Artificial' is an adjective which is in general use in the English Language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the appellants' first contention that its use by the draftsman of the subsection is pleonastic –

1. 24 of 1980.

that is a mere synonym for 'fictitious'. A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out.' 'Artificial' as descrptive of transaction is, in their Lordships view, a word of wide import."

The consequences of treating a transaction as artificial or fictitious, in the words of Lord Diplock are:

"To disregard a transaction means to treat it as if it had never been entered into, i.e., by any of the parties to it. So if the words which precede the comma are to be given their natural meaning they entitle the Commissioner when exercising any of his powers under the Income Tax Laws to treat the transaction as if it had never been entered into. As between parties themselves, the subsection does not purport to alter whatever legal rights or liabilities the transaction is capable of giving rise to notwithstanding its artificial character. These remain governed by the general law; so do the legal consequences as between the parties any action taken by the Commissioner in the exercise of his right to disregard the transaction for tax purposes."

The meaning of the words "and the parties concerned shall be assessed separately" can be found in the judgment of Lord Diplock although the Jamaican law refers to 'persons' while our law refers to 'parties'.

"The subsection confers on the Commissioner a general discretion whether or not to disregard the transaction, and, if this was all it had done, it would have been arguable that he was entitled to disregard the transaction for the purpose of assessing the party whose liability to tax it would have reduced, without being compelled to disregard it also for the purpose of assessing any other party whose liability to tax would have been increased by it. "The persons concerned" means all parties to the transaction; those whose liability to tax it would have increased as well as those whose liability to tax it would have reduced. The words "shall be assessable accordingly" are mandatory. They make clear what other wise might have been left in doubt; that if the Commissioner does elect to disregard a transaction he must do so as respects all the parties to it; and they confer upon those parties to the transaction whose liability would have increased a right to be re-assessed at the lesser amount, so that the net amount of tax recoverable by the Crown will be the same as it would have been if none of the parties to the transaction had entered into it."

In the case of *Dhavoodbhoy v. C.G.I.R.* S.C. 9/79 the Revenue sought to reject an agreement between a father and his children to share the profits and losses which he received as a partner in another partnership in which the share of the capital and the goodwill remained the separate asset of the father. The Supreme Court rejected that contention and held that where the agreement has been given effect to and is acted upon, such agreement cannot be rejected as artificial and fictitious.

"No doubt the Assessee has the right to terminate the agreement and until such termination he remains the owner of the capital and goodwill. This is a perfectly legal document. It incorporates a family agreement by which a father is seeking to provide for his children – a most natural desire, and if so minded, the children could enforce it in law. This kind of family arrangement is not only genuine but very common in our society. To brand it as artificial and fictitious is unwarranted and unjust. It incorporates a perfectly legitimate family transaction. "For acts and documents to be a 'Sham', with whatever legal consequences to follow from this, all the parties thereto must have a common intention that the acts and documents are not to create the legal rights and obligations which they give the appearance of creating" per Diplock J. in *Snook v. London & W. Riding Invest Ltd.* (1967) (I.A.E.R. 518 at 528). The accounts up to 31.3.1966 show that the agreement has been acted upon and profits divided in terms of A 1. I therefore reject the contention that it is artificial and fictitious". – Samarakoon C.J.

'A subject is entitled to arrange his affairs so as to reduce his liability to tax does not invalidate it unless a particular enactment so provide. Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. These principles propounded in the case of *Duke of Westminster v. I.R.C.*: 1936 A.C. 1 is still respected and followed. However, where it is found that where documents or transactions were genuine and are intended to have effect as a part of a nexus or series of transactions the court will not restrict itself to a step by step analysis and would consider the total effect of such scheme.'

"While obliging the Court to accept documents or transactions, found to be genuine, as such, it does not compel the Court to look at a document or transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole there is nothing in the doctrine to prevent it being so regarded: to do so is not to prefer form to substance, or substance to form. It is the task of the Court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded."– Lord Wilberforce in *Ramsay v. C.I.R.* House of Lords.

Chapter 25

LOSSES

A loss arises where there is an excess of expenditure over revenue for a particular accounting period. A loss for income tax purpose is a loss ascertained in accordance with the provisions of the Inland Revenue Act. When ascertained in this manner, a book loss may result in a profit while a book profit may result in a loss for tax purposes.

The manner in which a loss ascertained for tax purposes is set off against profits is considered under the following headings:

(a) Carry forward of losses.
(b) Loss on cessation of any trade, business, profession or vocation.
(c) Losses in undertakings related to tourist hotels.
(d) Losses of export undertakings.
(e) Losses of small and medium scale undertakings for the production or manufacture of commodities.
(f) Losses of undertakings for the milling of paddy.
(g) Losses of companies engaged in fishing, animal husbandry, sericulture and agriculture.
(h) Losses from the business of horse racing.
(i) Losses of an insolvent or a bankrupt.
(j) Losses incurred by a child.

1. General rules applicable for losses

The following rules are to be observed in the treatment of losses for tax purpose:

(a) The amount of the loss that can be allowed must be ascertained in the manner provided for the ascertainment of profits. S. 29(9).

(b) A loss can be deducted only if it would have been assessable had it been a profit. S. 29(b).

(c) The aggregate amount of the deduction from the statutory income in respect of any loss shall not exceed the amount of the loss. S. 29 2(b)(i).

(d) A deduction on account of a loss must as far as possible be made from the statutory income of the first year of assessment immediately following that in which the loss was incurred. S. 29(2)(b)(ii).

(e) Unabsorbed loss can be carried forward till the loss is fully absorbed. S. 29(1)(b)(ii).

(f) Loss incurred by a bankrupt before the date of bankruptcy or insolvency cannot be set off against income arising after that date. S. 29(8).

2. **Carry forward of losses of Trade, Business, Profession or Vocation**: S. 29(2)(b).

A loss which has not been allowed against the statutory income of the previous year of assessment can be carried forward till the loss is fully absorbed against the statutory income of the ensuing years of assessment.

Example:

Adjusted Loss for year ended 31.03.1982 — Rs. 80,000
Adjusted Profits for year ended 31.03.1983 — Rs. 20,000

Set off of loss is made as follows:

Year of Assessment: 1981/82:

Assessable Income for this year is nil.

The loss carried forward for the year of assessment 1982/83 is Rs. 80,000.

Year of Assessment: 1982/83:

	Adjusted Profits for the year	— Rs. 20,000
Less:	Loss brought forward from 1981/82	— Rs. 80,000
	Loss carried forward for 1983/84	— Rs. 60,000

3. **Loss on Cessation of Trade, Business, Profession or Vocation.** S. 29(5).

When a person ceases to carry on a trade, business, profession or vocation, and incurs any loss in that year of assessment, such person is entitled, on an application made in writing to the Commissioner General of Inland Revenue, to carry back such loss for the three years of assessment immediately preceeding that in which the loss was incurred. The set off of loss must, as far as is possible, be made from the statutory income of the first year of assessment immediately preceeding that in which the loss was incurred, and any unabsorbed loss is set off against the statutory income of the next preceeding year and so on. A loss which cannot be fully set off in the three preceeding years of assessments can be carried forward and set off against other sources of income of the taxpayer in the succeeding years.

Where loss is carried back, for three years, the assessments affected will be revised notwithstanding that those assessments are final and conclusive. However, there appear to be no provision in the law for repayment of tax paid, if any, unless a claim in writing has been made within three years of the end of each relevant year of assessments.

The facility to carry back lossess does not extend to

(a) a capital loss; and

(b) a loss from the business of horse racing.

Example:

A ceased to carry on his trade on September 30, 1982. He incurred a loss of Rs. 50,000 for the period 01.04.1982 to 30.09.1982. The income of the previous years are as follows:

Year ended 31.03.80	... ...	— Rs. 15,000
Year ended 31.03.81	... ...	— Rs. 10,000
Year ended 31.03.82	... ...	— Rs. 15,000

The year of assessment in which the loss was incurred was 1982/83. The three years of assessments for which unabsorbed loss can be carried back are as follows:

1981/1982
1980/1981
1979/1980 (Current year)

The loss will be set off as follows:

1981/82	— Assessable Income — Nil
1980/81	— Assessable Income — Nil
1979/80 (Current Year)	— Assessable Income — Nil

The balance of the unabsorbed loss of Rs. 10,000 can be carried forward and set off against other sources of income of the year of assessment 1982/83, and if such loss cannot be fully set off is carried forward for set off against the other sources of income of that person, in the subsequent years of assessments.

4. **Losses of Undertakings related to Tourist Hotels.** S. 29(3).

In the case of undertakings, connected with tourist hotels, any losses incurred during the tax holiday period can be deducted from the statutory income of that person who carried on that undertaking in the first year of assessment in which the tax holiday ceased to apply.

The amount of the loss that can be set off is:

(a) the total of any losses during the exempt period;

Less:

(b) the exempt profits and income for any year of assessment during the exempt period succeeding the year of assessment in which the loss was incurred.

Where the loss cannot be set off against the first year of assessment after the exempt period it can be carried forward and set off in the next succeeding years of assessment till it is fully absorbed.

Example:

AB Ltd., is an exempt tourist hotel which enjoys tax holiday for the period 01.04.78 to 31.03.83. The profit/loss of the Company is as follows during the exempt period.

	Profit	Loss
Year ended 30.03.1979	Rs. 5,000	—
Year ended 31.03.1980	Rs. 10,000	—
Year ended 31.03.1981	Rs. —	Rs. 20,000
Year ended 31.03.1982	—	Rs. 5,000
Year ended 31.03.1983	Rs. 20,000	—

The loss at the end of the exempt period available for set off against year of assessment 1983/84 is Rs. 5,000. Where the loss cannot be fully set off it can be set off against the profits of the year of assessment 1983/84 or if it cannot be so set off can be carried forward for set off against future years of assessment till the loss is fully absorbed.

5. Losses of Export Undertakings

Loss of export companies that can be carried forward is, the loss, which if it had been profit, would have been assessable to tax. Where the loss is entirely export loss, then no loss, can be carried forward and any loss, if any, at the end of the period of exemption cannot be carried forward for set off. The profit made on other turnover is liable to income tax and accordingly any loss thereof can be set off against other sources of income or carried forward. The non-export loss that can be carried forward can be arrived at by apportioning loss on the basis of turnover.

Example:

The total loss of Messrs. X Ltd., for the year ended 31.03.83 was Rs. 100,000. The company's total turnover was Rs.500,000 while its export turnover was Rs. 400,000.

$$\text{Other Loss} = \frac{\text{non-export turnover}}{\text{Total turnover}} \times \text{Total Loss.}$$

$$\text{i.e., } 100,000 \times \frac{100,000}{500,000} = 20,000$$

This loss of Rs. 20,000 can be set off against the other sources of income or can be carried forward indefinitely till the loss is fully set off.

6. Losses in small scale undertakings for the production or manufacture of commodities. S. 29(4)(a).

Small and medium scale undertakings are qualified only for a partial exemption of profits from income tax, the exemption being limited to Rs. 200,000 for any year of assessment. The balance of the income over this limit is liable to income tax.

Where such a company incurs a loss such a loss can be set off in the following manner.

(a) any loss incurred during the tax holiday period can be set off only against the excess of the profits over Rs. 200,000 of any year of assessment during the tax holiday period. Such loss cannot be set off against other sources of income of the person who carries on that undertaking.

(b) The balance of the loss if any, of the tax holiday period can be set off against the statutory income of that person for the year of assessment 1984/85 after making adjustment in respect of the following:

(i) Losses which have been set off against the statutory income of that undertaking of that person during the tax holiday period; and

(ii) the aggregate of the exempt profits for the years of assessment subsequent to that year of assessment in which the loss was incurred.

Example:

AB Ltd., carrying on the business of Importers and Exporters commenced an undertaking for the production of pencils on 01.01.1978. The undertaking was approved by the Minister as a company to which a limited tax holiday would apply and has satisfied all conditions necessary for the company to qualify for exemption. The trading results were as follows:

		Adjusted Profits/(Loss) of the undertaking Producing Pencils.	*Adjusted Profits of Export & Imports business.*
Year ended 31.03.1978	...	Rs. 75,000	Rs. 500,000
Year ended 31.03.1979	...	Rs. 150,000	Rs. 600,000
Year ended 31.03.1980	...	Rs. 200,000	Rs. 400,000
Year ended 31.03.1981	...	Rs. (200,000)	Rs. 300,000
Year ended 31,03,1982	...	Rs. (300,000)	Rs. 400,000
Year ended 31,03.1983	...	Rs. 250,000	Rs. 500,000
Year ended 31.03.1984	...	Rs. 225,000	Rs. 600,000

The Loss is set off as follows:

Exempt undertaking:

Year of Assessment 1980/81:

Loss for the year ...	...	...	Rs. 200,000
Loss set off in the year.	...	...	NIL
Loss carried forward	...	...	200,000

Year of Assessment 1981/82:

Loss for the year ...	...	...	Rs. 300,000
Loss brought down from previous year		...	Rs. 200,000
			500,000
Set off in the year	...	...	NIL
Loss carried forward	...	...	500,000

Year of Assessment 1982/83:

Profit for the year ...	...	...	Rs. 250,000
Less: loss brought forward	...	...	Rs. 500,000
Balance loss at the end of the tax holiday period			Rs. 250,000

Assessment of AB Ltd.,

Year of Assement 1980/81 profit	...		... Rs. 300,000
Year of Assessment 1981/82 profit	...		... Rs. 400,000
Year of Assessment 1982/83 profit	...		... Rs. 500,000
Year of Assessment 1983/84	...		
Profit from Imports & Exports	...	Rs. 600,000	
Profit from Pencil Manufacture	...	Rs. 225,000	
Total Profits of AB Ltd.,	...	Rs. 825,000	
Less: Loss of exempt Undertaking	...	Rs. 250,000	
Profit for the year ...	...		... Rs. 575,000

7. **Losses of Companies engaged in Fishing, Animal Husbandry, Sericulture and Agriculture.** S. 29(4).

Losses of companies engaged in fishing, animal husbandry, sericulture and agriculture incurred during the exempt period can only be set off during the period of exemption, against the exempt profits of the years of assessment subsequent to the year of assessment in which the loss was incurred. Any balance of the loss can be deducted from the income of the year of assessment 1985/86. Where such loss cannot be fully set off such loss can be carried forward and set off against profits of the next years of assessment and so on till it is fully absorbed. S. 29(4)(b).

The period of exemption from income tax in respect of companies engaged in Fishing, Animal Husbandry, Sericulture and Agriculture has been extended to March 31, 1985.[1] Accordingly any balance loss can be deducted from the statutory income of the year of assessment 1985/86. However, appropriate amendment to section 29(4)(b) has not been made and as the law stands the balance loss is deductible from the statutory income of the year of assessment 1983/84.

8. **Losses of undertaking for Milling of Paddy.**

A loss incurred in an undertaking for the milling of paddy, during the exempt period, can only be set off against the exempt profits of the years of assessment subsequent to the year of assessment in which the loss was incurred. Any balance of the loss can be set off from the total statutory income of the year of assessment 1983/84. Where such loss cannot be fully set off in the year of assessment 1983/84 such loss can be carried forward and set off against the next year of assessment and so on till the loss is fully set off.

9. **Losses from the business of horse racing.**

A loss from the business of horse racing can only be deducted from the profits from the business of horse racing in the subsequent years of assessment. A loss from the business of horse racing cannot be deducted from the statutory income of other sources.

Any unabsorbed loss from the business of horse racing can be carried forward and set off only against the profit from the business of horse racing in the future years of assessment. S. 29(7).

10. **Losses of an insolvent or bankrupt.** S. 29(8).

A loss incurred prior to the date of the bankruptcy or insolvency cannot be deducted from the income arising after the date on which such person has been declared or adjudged insolvent or bankrupt. S. 29(8).

11. **Losses incurred by a child.**

Where the statutory income of a child is aggregated with the income of a parent for any year of assessment, any loss which could have been deducted from the statutory income of such child can be deducted from the statutory income of the parent. S. 29(10).

---

1 40 of 1981

Chapter 26

PAYMENT OF TAX AND RECOVERY OF TAX IN DEFAULT

Payment of income tax, wealth tax and gifts tax for any year of assessment is governed by the Self Assessment Scheme whereby any person liable to tax is required to compute the income tax, wealth tax or gifts tax and pay such tax to the Commissioner General of Inland Revenue in four quarterly instalments, although no assessment has been made on him. S. 97(1). A quarterly instalment of a tax payable by any person is one quarter of the tax payable by him for that year of assessment. S. 97(2).

1. Due dates of quarterly instalments of tax.

The quarterly instalment of tax payable for any year of assessment must be paid by the taxpayer on or before the following dates:

First Quarter	—	On or before August 15.
Second Quarter	—	On or before November 15.
Third Quarter	—	On or before February 15.
Fourth Quarter	—	On or before May 15.

For example, the tax payable for the year of assessment 1982/83 is payable as follows:

First Quarter	—	On or before August 15, 1982
Second Quarter	—	On or before November 15, 1982
Third Quarter	—	On or before February 15, 1983.
Fourth Quarter	—	On or before May 15, 1983.

2. Penalty for non-payment of tax on the due date/s. S. 125(2).

Where any tax which a person is liable to pay in quarterly instalments has not been paid on or before the due date, such instalment of tax or part thereof which has not been paid is deemed to be in default and such person is liable to a penalty in addition to tax payable by him. The penalty payable by any person on the amount of tax in default is equal to:

(a) five percent of the amount of tax on failure to pay on or before the due date; and

(b) a further five percent of the amount in default in respect of each further period of three months or part thereof during which tax remains unpaid, where tax is not paid within thirty days of the due date for payment.

3. **Limit on the amount of penalty.**

The total amount payable as penalty by any person for failure to pay tax on the due date shall not exceed fifty percent of the tax in default. S. 125(2) Proviso (i).

(a) **Years of Assessment 1979/80 and subsequent years.**

The total amount payable as penalty for failure to pay the tax on the due date shall not exceed fifty percent of the tax in default. S. 125(2) Proviso (i).[1]

(b) **Years of Assessments prior to 1979/80.**

Where any tax is outstanding payable in respect of years of assessments prior to 1979/80, the defaulter is liable to a penalty of twenty five percent as imposed by section 96B(6) of the Inland Revenue Act No. 4 of 1963 and a further penalty of twenty five percent on the amount of the tax in default as at April 01, 1981.[2] The maximum amount of penalty payable does not exceed fifty percent: S. 125(2A).

The provisions of section 96B of the Inland Revenue Act No. 4 of 1963 apply for the years of assessments commencing on April 01, 1972 and subsequent years, and will therefore apply to tax in default in respect of years of assessment 1972/73 and subsequent years.

4. **Operation of the penalty under the current year basis of assessment.**

Since the statutory income of a person for an year of assessment on which such person is chargeable with income tax is on the profits and income which arose or accrued during the year of assessment, it may not be possible to determine the correct amount of the tax payable till accounts are made up as at March 31, at the end of the year of assessment. Therefore, it has been provided that no penalty will be incurred where any person had paid quarterly instalment of tax for an year of assessment a sum which is not less than one quarter of the income tax and wealth tax payable by such person for the year immediately preceeding that year of assessment. S. 125(2) Proviso (ii).

Where quarterly instalment of tax has been paid on the basis of tax payable for the year immediately preceeding the year of assessment and the tax for the current year exceeds the amount of tax of the previous year of assessment, the excess can be paid without incurring penalty, if such amount is paid by November 30, immediately following that year of assessment. Where it is estimated that the tax for the current year is likely to be less than the tax for the previous year, the instalment of tax may be suitably adjusted.

Income tax payable by Mr. Perera for the year of assessment 1981/82 was Rs. 10,000. The tax due for 1982/83 is estimated to be around Rs. 25,000. The instalment of income tax is as follows:

1st Quarter	— On or before August 15, 1982	— Rs.	2,500
2nd Quarter	— On or before November 15, 1982	— Rs.	2,500
3rd Quarter	— On or before February 15, 1983	— Rs.	2,500
Fourth Quarter	— On or before May 15, 1983	— Rs.	2,500
Final Payment	— On or before November 30, 1983	— Rs.	15,000

1 24 of 1980. 2. 40 of 1981.

Example II:

Income tax payable for the year of assessment 1981/82 was Rs. 10,000. The tax payable for the year of assessment 1982/83 is estimated at Rs. 6,000. Where it is possible to estimate the liability correctly the instalments may be paid as follows:

First	instalment – On or before August 15, 1982	—	Rs. 1,500
Second	instalment – On or before November 15, 1982	—	Rs. 1,500
Third	instalment – On or before February 15, 1983	—	Rs. 1,500
Fourth	instalment – On or before May 15, 1983	—	Rs. 1,500

Where the actual liability, for example, works out at Rs. 10,000, penalty will accrue on the balance Rs. 1,000 of the instalment payable.

5. **Example of determining rate of penalty payable.**

The following table will indicate the rate at which penalty is payable where tax has not been paid on the due date for the year of assessment 1982/83.

The date on or after	*Quarter 1*	*Quarter 2*	*Quarter 3*	*Quarter 4*
15.08.82	05	—	—	—
15.12.82	10 (15.11.82)	05	—	—
15.03.82	15	10 (15.02.83)	05	—
15.06.83	20	15	10 (15.05.83)	05
15.09.83	25	20	15	10
15.12.83	30	25	20	15
15.03.84	35	30	25	20
15.06.84	40	35	30	25
15.09.84	45	40	35	30
15.12.84	50	45	40	35
15.03.85	50	50	45	40
15.06.85	50	50	50	45
15.09.85	50	50	50	50

Where tax due for the year of assessment 1982/83 remains unpaid on 15.09.85 a penalty of fifty percent of the tax payable will accrue and is payable. Quarterly instalment of tax payments made after August 15, 1982 and before September 15, 1985 will suffer penalty at rates indicated in the foregoing table.

The penalty of 5% will accrue immediately on failure to pay, in the above example, after 15.08.82, 15.11.82, 15.02.83 and 15.05.83 and further penalty will commence to accrue if that instalment is not paid within 30 days after 15.08.82, 15.11.82, 15.02.83 and 15.05.83. Additional penalty, not exceeding fifty percent of the tax will accrue in respect of each further period of three months or part thereof. S. 125(2)(b).

6. **Issue of assessment to enforce payment of tax.**

Where tax has not been paid under the self assessment scheme by a person who is liable to tax, the tax is deemed to be in default and an Assessor is empowered to issue an assessment to enforce payment of tax. An Assessor can also issue assessment on a person where he is satisfied that such person has paid tax less than an amount with which he is properly chargeable.

The assessment raised will specify the date by which such tax should be paid. Where tax is not paid by that date the tax is deemed to be in default and the department will enforce payment under powers vested in them.

7. **Tax in default.**

Where any tax is unpaid the tax will be deemd to be in default and the Revenue is empowered to take certain measures to enforce payment. Tax will be deemed to be in default in the following circumstances:

(a) Where a quarterly instalment of tax has not been paid on or before the due date or where a person has been charged with income tax, wealth tax or gifts tax by an assessment and tax has not been paid on or before the date specified in that assessment, the amount of tax unpaid shall be deemed to be in default. S. 125(1).

(b) Where tax has been held over pending the settlement of appeal and the Commissioner General has revoked the order of hold over and requires that the tax be paid on a specified date, any tax unpaid after that date will deemed to be in default. S. 125(5).

(c) Where upon the final determination of an appeal, any tax held over becomes payable or that tax charged under the original assessment has been increased, and the Commissioner General requires such person to make payment on a certain date, any tax unpaid after such date will be deemed to be in default. S. 126(6).

(d) Where part of the tax has been held over by the Commissioner General and in the course of the appeal the tax payer agrees that certain sums are likely to be due in respect of the assessment under appeal, and the tax payer was required to pay such tax on a specified date, any payment not made on that date will be deemed to be in default. S. 125(7).

(e) In the case of any tax due from the estate of a deceased person any tax unpaid after two months of the date of the grant of probate or letters of administration shall be deemed to be in default. However, where the executor takes possession of or intermeddles with the property of the deceased, tax unpaid on or before the due date is deemed to be in default. S. 125(10).

8. **Tax not in default.**

Tax will not be deemed to be in default in the following circumstances:

(a) Where the Commissioner General allows time or instalments to pay tax on being satisfied that the taxpayer had made arrangements to pay the tax from:

(i) any sum to be paid to him by the Government;

(ii) the moneys lying to his credit in the National Savings Bank;

(iii) any moneys to be paid to him from any pension or provident fund approved by the Commissioner General: S. 125(9).

(b) In the case of the tax liability of a deceased person, where the Executor is unable to make payment owing to probate or letters of administration not being granted and that he has notified the Commissioner General of this fact, the unpaid tax is not deemed to be in default. S. 125(10).

(c) Where the Commissioner General has ordered that the tax be held over pending the settlement of appeal, the amount of the tax held over will not be deemed to be in default. S. 125(4).

9. Definition of 'Tax' for Recovery Proceedings

The word 'tax' includes the following:

(a) Income Tax, Wealth Tax and Gifts Tax charged or levied under Inland Revenue Act No. 28 of 1979.

(b) Income Tax, Wealth Tax and Gifts Tax charged or levied under Inland Revenue Act No. 4 of 1963. as amounts which are in default on April 01, 1981.

(c) Any income tax which an employer is required to pay under Pay As You Earn scheme of taxation.

(d) Any sums added to income tax, wealth tax and gifts tax as Penalty.

(e) Any fines, penalties, fees or costs incurred under the provisions of the Inland Revenue Act. S. 126.[1]

10. Tax in default is the first charge on the assets of the defaulter. S. 127(1).

Tax in default will be the first charge upon all assets of the defaulter. However, the charge will not extend in the following circumstances.

(i) tax in default will not affect the title of any assets sold by the defaulter to a *bona fide* purchaser for value before the seizure of property for recovery of tax or the vesting of immovable property in the State for purposes of recovery;

(ii) tax in default will not rank in priority as charge as regards immovable property in respect of any lease or encumbrance created *bona fide* for value and registered prior to the seizure;

(iii) in respect of movable property where tax is for more than one year in default, the tax for one year only selected by the Commissioner General will rank in priority to any lien or encumbrance created *bona fide* for value prior to the date of default.

11. Insolvency, Bankruptcy or Liquidation.

A receiver is liable to pay out of the assets under his control tax charged or chargeable for one complete year of assessment selected by the Commissioner General in respect of the liability prior to the date of insolvency, bankruptcy or liquidation and will rank as the first charge of the assets. Any other tax charged or chargeable for the periods prior to such date will rank as an unsecured debt. S. 127(2).

When the Commissioner General is satisfied that the tax collectable is excessive on representation made by the receiver, he has the discretion to make such adjustments as may be necessary and is reasonable notwithstanding that the assessment is final and conclusive.

Insolvency is no bar for any proceedings against the taxpayer for failure to pay the tax due, even though protection is available from a creditor under the Insolvency Ordinance. (*F. E. Smale v. C.I.R.* 3 CTC 417).

---

1. 40 of 1981.

12. Liability of certain persons to account for tax in default.

Where a private company is wound up and where any income tax which that company is liable, whether the assessment of such tax was made before or in the course of or after its liquidation, cannot be recovered, then every director of the company at the time during the year of assessment in respect of which such tax is charged shall be jointly and severally liable for the payment of such tax. He cannot escape liability unless he proves that the default in payment cannot be attributed to the gross neglect, misteasance or breach of duty on his part in relation to the affairs of the company. S. 141(1).

13. Revision of Assessment not under appeal on objections made at the time of notice of recovery proceedings. S. 128.

Where any tax is in default, the Commissioner General shall issue a notice to the defaulter in writing stating the amount of tax in default and that action is being taken to commence recovery proceedings.

Where the defaulter has not appealed against that assessment, he may make his objections to the tax charged within thirty days of the date of such notice. The Commissioner General shall consider his objections notwithstanding that such assessment is final and conclusive and give his decision which shall be final. S. 128(2).

A taxpayer who has not made a valid appeal against an assessment must avail of this provision to have the assessment amended prior to proceedings for recovery of tax is commenced before a Magistrate.

When no objections have been made, the assessment will be final and conclusive and the taxpayer will not have any further opportunity to dispute the assessment made on him.

14. Procedure for recovery of tax in default.

When tax is in default, the Commissioner General is vested with wide powers to enforce the payment of tax. These powers would fall under the following headings:

(a) recovery of tax by seizure and sale. S. 129.

(b) proceedings before a Magistrate to enforce recovery of tax. S. 130.

(c) recovery of tax out of debts owing to the defaulter. S. 131.

(d) recovery of tax from persons leaving Sri Lanka. S. 138.

(e) powers of the Commissioner General to require information for purposes of recovery. S. 140.

(f) recovery of tax from remuneration of employees. S. 132.

(a) Recovery of tax in default by seizure and sale of property.

Where tax is in default the Commissioner General may issue a certificate to a Government Agent, Assistant Government Agent, Fiscal, Deputy Fiscal or a Tax Collector giving the details of the tax in default and the name of the defaulter and require him to seize and sell movable property of the defaulter in satisfaction of the tax in default. S. 129(2)(a).

If the property seized is cash in Sri Lanka currency shall be first applied in the payment of the costs and charges of seizing and any balance applied in satisfaction of the tax in default.[1]

Where the property seized is foreign currency it shall be deposited with the Central Bank and the proceeds therefrom applied in the payment of the costs and charges of seizing and any balance applied in satisfaction of the tax in default.[1]

When the property seized is not in cash, such property will be kept in custody for Five Days at the expense of the defaulter. If the defaulter does not pay the tax in default within the period of five days, the property will then be sold by public auction. Where the property is a negotiable instrument or a share in any corporation or a public company it shall be sold through a broker at the market rate of the day. S. 129(2)(c)(iii).

The sum realised by public auction will be applied in the following manner:

(i) firstly, in payment of cost and charges of seizing, keeping and the selling of the property;

(ii) secondly, in satisfaction of the tax in default;

(iii) thirdly, any balance will be restored to the defaulter. S. 129(2)(d).

Application to Court for issue of Writ to the Fiscal. S. 129(3).

When the Commissioner General considers that the recovery of tax by seizure and sale of movable property is impracticable or inexpedient he can issue a certificate to a District Court having jurisdiction in any district where the taxpayer resides or in which any movable or immovable property owned by the defaulter is situate giving details of the name of the defaulter and the amount of the tax in default. A similar notice shall also be sent by him to the defaulter by personal service, by registered letter through post or telegraph; but any non-receipt of such notice does not invalidate the proceeding for recovery. The Court will thereupon direct a writ of execution to issue to the Fiscal to seize and sell all and any of the movable or immovable property as may be necessary to satisfy the tax in default. The Civil Procedure Code sections 226 to 297 will apply to such seizure and sale. S. 129(3).

The manner in which the Commissioner General will proceed to recover tax, is in the absolute discretion of the Commissioner General and he can proceed to recover tax under any of the provisions available to him. It is not necessary for him to express an opinion that the recovery by means of any section provided for recovery is practicable or not. *D. J. Ranaweera v. C.I.R.* 3 CTC 238; *De Vos v. C.I.T.* 1 CTC 23.

In the case of a writ issued for seizure and sale of immovable property by the District Judge on a certificate issued by the Commissioner General there is no right of appeal to the Appeal Court from the Order of the Supreme Court dismissing an appeal in respect of such proceedings, as the Commissioner General is performing a ministerial function and the proceedings do not have the character of a civil suit. *D. J. Ranaweera v. C.I.R.;* 3 CTC 366.

The Commissioner General has the discretion of deciding whether or not the recovery of tax in default would await the determination of appeal.

1. 27 of 1982.

yet under the Civil Procedure Code, the Court could only stay its own proceedings upon such conditions as is available under that code, and the tax law does not expressly or impliedly preclude such an order. Thus in the case of writ issued for the seizure and sale of property, the District Judge will have the power to stay the execution of the writ upon conditions usually invoked under section 761 of the Civil Procedure Code, by judgment debtors in civil actions. The conditions under which stay is ordered is after a deposit of a sum in cash which is normally relied by the Courts for staying its decree for execution. *D. J. Ranaweera v. C.I.R.;* 2 CTC 366.

(b) **Proceedings for recovery before a Magistrate.** S. 130(1).

The proceedings for recovery of tax before a Magistrate is of a very drastic character, in that the tax is imposed as a fine to compel payment of tax by imposing the sanction of imprisonment in default of payment. The tax due is deemed to be a fine for the purpose of invoking the provisions of the Criminal Procedure Code section 191(1) relating to the imposition of a term of imprisonment in default of payment of tax.

When the Commissioner General considers necessary to commence proceedings before a Magistrate to recover tax in default, he will issue a certificate to a Magistrate having jurisdiction in the division in which the defaulter is having business or residence setting out the amount of the tax in default. The Magistrate will thereupon summon the defaulter to show cause as to why he should not be proceeded with and on his failing to do so will impose the tax as a fine. The Magistrate may make any direction within the provisions of the Criminal Procedure Code. S. 130(1).

Although the proceedings before a Magistrate is of a drastic character, the Commissioner General could proceed with this action notwithstanding that he had not proceeded with the provisions of seizure and sale of property. The mere fact that a proceeding under one section is of more or less drastic character does not limit the Commissioner General's power to take proceedings before a Magistrate to recover the tax in default. *De Vos v. C.I.T.f* 1 CTC 23.

In any proceeding before a Magistrate the Commissioner General's certificate that an amount of tax is in default is sufficient evidence and the Magistrate cannot consider or decide the correctness on the ground that an appeal against the assessment proceeded with is pending. S. 130(2). The Commissioner General's certificate shall be sufficient evidence that the tax has been duly assessed and is in default and any plea that the assessment is excessive incorrect or under appeal shall not be entertained. S. 130(7).

The evidence of the Commissioner General is merely sufficient evidence and not conclusive evidence that the tax has been duly assessed and is in default. The purpose of this provision is to prevent a defaulter who had been duly assessed to tax for which he is properly chargeable from reagitating in the course of proceedings for recovery as to the correctness of the assessment served on him. *De Silva v. C.I.T.* 1 CTC 410. The Courts, however, considering the drastic nature of the proceedings to deal with the defaulter as if he had been convicted of a Criminal Offence have allowed opportunity to show cause in the following circumstances:

(a) a defaulter is not precluded from showing that the Magistrate has no jurisdiction because his last known place of business or residence does not fall within the local jurisdiction of the Magistrate; he may also show that he has paid the tax due; or that he is not the defaulter in that he is not the person assessed but it is open to the defaulter to question the correctness of the amount specified in the certificate. *S.I. Mendis v. C.I.T.;* 1 CTC 569;

(b) There is nothing in the provisions to prevent the taxpayer from proving that the assumption that the amount stated in the certificate is incorrect even though the certificate assumes that the alleged defaulter had been duly assessed. *K. G. W. Nilaweera v. C.I.T.;* 3 CTC 132.

(c) It is open to the party summoned before the Magistrate to show either that he is not a defaulter in the sense that he has in point of fact paid and discharged any duty imposed on him or that he is not a defaulter in the sense that he was not the person who was assessed but he was a third party. *Guillain v. C.I.T.;* 1 CTC 450.

(d) a defaulter in proceeding before a Magistrate cannot be prevented from satisfying the Magistrate that he was not duly assessed or that he was not the defaulter in respect of the tax for which he was properly chargeable. "No person should be exposed to the drastic penalties unless and until he has personally received the notice of assessment charging him with the liability which, if disputed, could be challenged in appropriate proceedings". *M. E. De Silva v. C.I.T.;* 410. A Managing Director of a Company cannot be proceeded against for recovery of tax due by the company as the person who is properly chargeable with tax is the company and not the managing director and accordingly the Managing Director was not personally liable, for tax due by the company. *Ranjit Wijemanne v. C.I.T.;* 1 CTC 437.

(e) the taxpayer is entitled to show that the tax for which he is proceeded with has been paid and the Magistrate must consider this objection. *A. R. Hamid v. C.I.T.;* 3 CTC 363.

(f) If the particulars of the tax taken to Court is insufficient, the matter should be raised before the Magistrate and he has the jurisdiction to order further particulars be furnished. *William v. C.I.T.;* 1 CTC 473.

Fine and Imprisonment.

When a person who has been summoned to show cause, fails to do so, the amount of the tax in default shall be deemed to be a fine imposed by a sentence of a Magistrate on such defaulter for an offence punishable with fine only or not punishable with imprisonment, then the provisions of the Criminal Procedure Code section 291(1) become applicable and the Magistrate is empowered to make any direction under provisions of the Criminal Procedure Code, in imposing a sentence. S. 130(1).

The power vested in a Magistrate under section 291(1)(b) of the Criminal Procedure Code of directing that an offender shall suffer a term of imprisonment in default of payment of a fine to which he is sentenced can be exercised only at the time of imposition of the sentence and not thereafter. Even where such direction has been made by the Magistrate that in default the offender would have to be committed to prison unless time is allowed under section 291(4) of the Criminal Procedure Code. A Magistrate is empowered to allow time for the payment of tax or direct payment by instalments and also enlarge the defaulter on bail. S. 130(6) but it will be observed that these indulgences can be granted to a defaulter only after, and not before a direction has been made, that on failure to pay the tax he shall suffer imprisonment. Where at the time when the defaulter appears on summons he has no sufficient cause to show against further proceedings, and the Magistrate merely makes an order that he should pay the tax without giving any direction that in default of payment he shall suffer a term of imprisonment, It is not open to the Magistrate to give that direction subsequently: *De Jong v. C.I.T.;* 1 CTC 507.

The Magistrate has the discretion whether or not to direct by sentence that in default of payment of the fine the offender shall suffer imprisonment for a certain term. Although in many cases, a Magistrate may decide to impose a term of imprisonment in default, there may be some cases where he does not think such action is called for: *Charlotte Beatrice Perera v. C.I.R.;* 3 CTC 245. In this case the taxpayer was found to have no present means of paying the tax imposed as a fine and it was observed that an imposition of a term of imprisonment "can hardly be said to be necessary to ensure recovery of the tax."

The intention of the legislature is that in special circumstances the Magistrate may desist from imposing a penal sentence.

"When the legislature, in empowering a Magistrate to deal with a defaulter in the same manner as if he had been convicted of a criminal offence, afforded an opportunity to the defaulter to show cause why he should not be thus dealt with, the Legislature must surely have inteded that in special circumstances a Magistrate could desist from imposing the penal sanction. Such special circumstances are in my opinion made out if it is shown that the default in payment was due to causes beyond the control of the defaulter, and that there was no lack of good faith on his part, and that at the time when section .... is invoked the defaulter has not the means to make the payment. The provision for cause to be shown negatives an intention to extract a pound of flesh in every case of non-payment of income tax." – Fernando J. in the case of *Puswella v. C.I.T.;* 1 CTC 564.

Proceedings before a Magistrate does not put an end to liability. S. 154.

The institution of proceedings for, or the imposition of, a penalty, fine or term of imprisonment shall not relieve any person from liability to assessment, or payment of any tax for which he is or may be liable.

Refund of tax paid as a fine to the Courts.

Where an order of a Magistrate imposing a fine is set aside on the ground of the order being illegal, any payment made under such order must be refunded: *Ranjit Wijemanne v. C.I.T.;* 1 CTC 437.

(c) **Recovery of tax out of Debts.** S. 131.

Where any person who –

(i) owes or is about to pay money to the defaulter or his agent; or

(ii) holds money for or on account of the defaulter or his agent; or

(iii) holds money on account of some other person for payment to the defaulter or his agent; or

(iv) has authority from some other person to pay money to the defaulter or his agent;

the Commissioner General may require such person owing money to the defaulter to pay such money in satisfaction of the tax in default. When they issue such a notice, he shall send a copy of such notice to the defaulter by post. The notice will apply to all such moneys which are in his hands or due from him or about to be paid to him at the date of receipt of such notice, or come into his hands or become due from him or are about to be paid to him at any time within a period of three months affer the date of such notice. S. 131(1).

The person who has made any payment to the Commissioner General in pursuance of such notice is deemed to act on the authority of the defaulter and is indemnified in respect of such payment against all proceedings, civil or criminal, notwithstanding the provisions of any other written law, contract, or agreement. S. 131(2). Where a person to whom this notice is issued is unable to comply with this order owing to the fact that the moneys in question do not come into his hands or become due from him during the period of three months shall within fourteen days of the expiry of this period inform the Commissioner General acquainting him of these facts. S. 131(3).

Any person who fails to comply with the order made by the Commissioner General shall if he is an individual be liable or where such a person is a company or body of persons, whether corporate or unincorporate the Secretary, Manager or other principal officer of such company or body of persons, shall be personally liable for the whole of such tax which he was required to deduct and can be recovered from them, as if such person were a defaulter. S. 131(4).

A defaulter for the purpose of these proceedings will include the agent of the person who is in default and in the case of a deceased person:

(a) the executor or adminstrator; or

(b) any person who takes possession of or intermeddles with the property of the estate of the deceased persons; or

(c) any person who has applied or is entitled to apply for the grant or resealing of probate or letters of administration. S. 131(5).

(d) **Prevention of persons leaving Sri Lanka for non-payment of tax.** S. 138.

Where the Commissioner General is of opinion that any person who is about to leave Sri Lanka without paying all income tax, wealth tax or gifts tax assessed upon him may issue a certificate giving particulars of tax in default and the name cf the defaulter to a Magistrate. The Magistrate shall thereupon direct the Inspector General of Police to take such steps as may be necessary to prevent such person leaving Sri Lanka without paying the tax or furnishing security to the satisfaction of the Commissioner General in respect of the tax in default. S. 138(i). When the Commissioner General issues a certificate to a Magistrate he shall issue to the defaulter a notification by personal service, registered letter or telegraph and any non-receipt of such notification will not invalidate any action taken under this provisions. S. 138(2).

When such order has been made, the following shall be sufficient authority for allowing such person leaving Sri Lanka:

(i) Production of a certificate signed by the Commissioner General, or a Deputy Commissioner to the effect that the tax had been paid or that security has been furnished; or

(ii) Payment of the tax to a police officer in charge of a Police Station.

(e) The power of the Commissioner General to require information for the purpose of tax recovery.

The Commissioner General may require any person to furnish him within a specified period information which he may require for the purpose of recovering tax in default and any such person is bound to furnish such information. S. 140.

(f) Recovery of Tax in default from remuneration of employees. S. 132(i).

The Commissioner General may require any employer or the person responsible for the payment of remuneration to deduct from the remuneration of such employee any tax in default in such number of monthly instalments as is specified by him. Where tax is so deducted by an employer the employee is deemed to have paid such tax deducted from the remuneration. The Commissioner General may withdraw such direction partly or wholly if the employee has made arrangements to the satisfaction of the Commissioner General. S. 132(3).

Where an employee is about to leave or leaves his employment the employer shall deduct the whole of such tax or any balance thereof which he has been directed to deduct by the Commissioner General. S. 132(4)

Where a direction is issued by the Commissioner General to deduct tax and the employer is unable to deduct tax due to the reason that such employee has left his employment, the employer must inform the Commissioner General of this fact immediately. Where the employer has failed to comply with the direction to deduct tax, such employer will be personally liable for the whole of the tax which he was required to deduct. Where the employer is a Company or a body of persons, the Secretary, Manager or other principal officer shall be personally liable for the whole of such tax.

Every employer who deducts tax from an employee, shall on request made by such employee issue him a certificate in such form as may be specified by the Commissioner General. S. 132(7).

15. **Transfer of Immovable property to Government in lieu of Payment of tax in cash.** S. 131A[1]

Any person liable to pay any tax may apply to the Commissioner General of Inland Revenue to transfer any immovable property owned by such person to the Government in lieu of payment of tax in cash at such value as is placed on such property by agreement with the Commissioner General. The Commissioner General may allow such application having regard to the feasibility of managing such property after it is transferred to the Government.

Where the value of the property as agreed exceeds the amount of the tax payable, such excess shall be deemed to be a donation to the Government of Sri Lanka and will be a qualifying payment of that person for that year of assessment. Such person is entitled to deduct from his assessable income the amount regarded as donation to the Government.

1. 24 of 1980.

Chapter 27

PAY AS YOU EARN

Pay As You Earn System provides for the deduction of income tax from the remuneration of employees by the employer at the time of the payment. The employer is required to deduct the income tax and account to the Inland Revenue and the amount of tax deducted by the employer is deemed to be income tax paid by the employer on the date on which such deduction was made. S. 98. To facilitate the deduction of income tax when remuneration is paid to an employee, the basis of assessment of profits from any employment is on the current year basis, providing for the assessment of such profits in the year of assessment. S. 2.

The deduction of income tax by the employer is on the basis of the schedule of tax applicable for the year of assessment provided by the Inland Revenue. S. 100(1). The schedule gives the appropriate tax to be deducted from the remuneration of the employee.

1. Income covered under the PAYE System.

The income covered under the PAYE System is any profits from any employment carried on or exercised by the employee. S. 98. Profits from any employment has been discussed in detail in Chapter 16.

2. Employee to whom the PAYE System will apply. S. 113.

A person who is in recept of remuneration whether in cash or otherwise for services rendered and include the following:

(a) A director of a Company or Corporation.

(b) Any working partner in a partnership.

(c) A person receiving remuneration for past services performed by him or performed by any other person.

Remuneration means profits from any employment. S. 113.

3. Employer.

Every person who is an employer has certain obligations with regard to the operation of the PAYE system. An employer includes any person, partnership, body of persons or any organisation:

(a) for whom an individual performs services as an employee;

(b) paying any profits from employment;

(c) paying any pension or other remuneration to a former employee or to any other person for the past services of such employee. S. 113.

In the case of a body, institution or person the following will be regarded as an employer:

(a) The Secretary, Manager or other principal officer of a Company or a Body of Persons.

(b) The Precedent Partner or any active partner resident in Sri Lanka of a Partnership. Where there is no active Partner resident in Sri Lanka, the agent of the partnership.

(c) The Executor or the Administrator of the estate of a deceased person.

(d) A trustee or trustees of a trust.

(e) The agent or the Attorney of a non-resident person.[1]

4. **Obligations of Employers in the operation of PAYE System.**

An employer is required to do the following in the operation of the PAYE system.

(a) To maintain a separate pay sheet on the prescribed form for each of his employees coming within the scope of the PAYE system and note therein particulars of all profits from employment liable to income tax. S. 102(a). The employer shall retain all such records for a period not less than five years after the end of the year of assessment to which such record relates. S. 102(b)

(b) To deduct the correct amount of income tax before the salary or wages is paid to his employee for any pay period. S. 98(1).

(c) To deduct the correct amount of the income tax by applying the correct table supplied by the department. S. 100.

(d) Pay all the income tax deducted from the employees remuneration to the Commissioner General of Inland Revenue on or before the 15th day of the following month. S. 103(a).

(e) Forward a monthly statement on the prescribed form showing the total amount of income for that month of the employees for whom pay sheets were maintained and the total income tax deductible. S. 103(a).

(f) Furnish to the Inland Revenue Department on or before the 30th of April each year annual return and the Income Tax Deduction Cards of his employees. S. 103(d).

(g) Furnish on or before 30th April to each of his employees from whose remuneration income tax has been deducted, an income tax deduction certificate on form PAYE T10 for the period 1st April of the preceeding year of Assessment to 31st March. S. 103(b).

(h) Furnish to the department not later than the last day of the month following in any year of assessment in which the employer ceased

1. 27 of 1982.

to carry on any trade, business, profession or vocation the annual return and the Income Tax deduction Cards of his employees. S. 103(c).

(i) Within thirty days after the cessation of employment deliver to the employee PAYE T10 form giving details of income tax deducted from 1st April to the date of cessation of employment. S. 103(c).

5. **Application of Tax tables.**

For the purpose of arriving at the amount of income tax deductible from individuals in receipt of income from employment tax tables are classified into five groups.

(a) Tax table applicable in respect of regular profits from employment Table I

(b) Tax table applicable in respect of lump sum payments – Table 2.

(c) tax table applicable for once-and-for all payments – Table 3.

(d) Tax table applicable for employees not resident in Sri Lanka – Table 4; Please see para 14 below.

(e) Tax Table applicable to marginal cases – Table 5: Please see para 13.

Tax Table applicable to regular profits – Table 1. S. 100(a).

Regular profits are payments made in any pay period. A pay period is a month, or a week or such other period in respect of which remuneration is calculated and paid by the employer. S. 113. Regular profits of employment will cover the following. S. 100(a):

* Wages, salary, leave pay, pension.
* Regular monthly payment of overtime pay, gratuities, perquisites and allowances.
* Withdrawal from an approved provident or pension fund or regulated provident fund to the extent such sums represent contributions by the employer or employees contributions to 01.04.1954.
* Travelling allowances.
* Tips, rewards, gratifications and such other payments whether legal or otherwise.
* Rental value of free quarters provided by the employer up to 25% of the gross salary.
* Excess of rental value of quarters provided by the employer over the rent paid by the employee for such quarters.
* Value of free transport, holiday warrants, passage granted to employees or to any members of his family.
* Payments made to any persons for the benefit of the employee or any member of his family, e.g. income tax, life insurance premia, servants wages etc.
* Value of free board, lodging, medical aid, fuel, lights, etc. granted to employees or to any member of his family.
* The total of lump sum payments or once and for all payments which does not exceed Rs. 500.

Tax Table applicable to lump sum payments – Table 2. S. 100(4).

These payments are received in one lump sum and will affect the calculation of tax in that month when the rate schedule applicable to regular profits are applied. Payments which are regarded as lump sum payments are:

* Bonus, Commissions, accumulated overtime pay and such other lump sum payments.
* Allowance granted to employees for the purchase of a vehicle.

A bonus voted and credited to the current account of the directors was held to have been paid on the date the bonus was credited to their current accounts of the directors. *Garforth v. Newsmith Stainless Ltd.* (November 21, 1978). When the bonus was placed to the credit of the current account of the directors the accounts were at the disposal of the directors who could have drawn the money at any time they chose and therefore amounts to a payment and the company was held to be liable for the income tax it ought to have deducted at the time the bonus was credited to the current accounts of the directors, *Garforth v. Newsmith Stainless Ltd.* (November 21, 1978).

Thus where the bonus has been voted and credited to the Directors' Current Accounts the Company should account to P.A.Y.E. tax in that month. This position would generally apply to private limited liability Companies where the directors may sometime leave the bonus undrawn.

Tax Table applicable to Once-and-for-all payments.

Regular profits and lump sum payments attract tax at normal rates of taxation while once and for all payments are taxed at a concessionary rate of taxation at the following rates:[1]

On the first	Rs. 50,000	Nil
On the next	Rs. 25,000	5%
On the next	Rs. 25,000	10%
On the balance		15%

Once-and-for-all payments are received on the termination of employment and will include the following:

* Retiring Gratuity;
* Compensation for loss of office or employment;
* Commuted pension;
* Sums paid from an approved provident or pension fund or regulated provident fund at the time of retirement.

The concessionary rate of tax will apply in respect of once-and-for-all payment only where such payments are made in accordance with a scheme which is uniformly applicable to all individuals employed by such employer.

Where the once-and-for-all payments are paid under a scheme which is not uniformly applicable to all individuals employed by such employer such payments will be liable to income tax at the normal rates of taxation and Tax Table No. 1 will apply to such payment.

---

1. 24 of 1980.

6. Application for direction to Employer:

An employee may apply to the Commissioner General of Inland Revenue to issue a direction to the employer to vary the application of the tax tables provided by the Department of Inland Revenue. An employee may make a request for a direction when;

(a) the amount of the income tax payable by him for any year of assessment is less than the tax deductible on the basis of the Tax Tables; or

(b) the amount of the tax already deducted is in excess of the amount that should have been deducted. S. 101(1).

In working out the Tax Tables the Department of Inland Revenue has provided for a deduction of Rs. 1,000 per month in respect of personal allowances and a sum equivalent to 6% of the gross income (up to a monthly income of Rs. 2,340) on aćcount of approved Provident Fund. Where the deductions from the assessable income of an employee exceed these amounts the tax deductible on the basis of the tax table provided by Inland Revenue will be more than the tax payable by him. In such cases the employee may apply for a direction to the Commissioner General of Inland Revenue.

Instances where an employee who is subject to deduction of tax under PAYE Scheme may require a direction are where;

(a) He would have no taxable income when all deductions are taken into account;

(b) Such employee makes any payment of interest, annuity, or ground rent in the year of assessment;

(c) The employee has made investments which qualify for deduction as qualifying payments mapyments;

(d) Once-and-for-all payments are received to determine the rate of tax applicable to such payments;

(e) The taxpayer is entitled to credit on account of tax deducted on dividend received by him;

(f) Loss incurred by the employee in any trade or business carried on by him which is likely to reduce his tax liability.

A direction issued by the Commissioner General will apply to the period specified in that direction.

An employee who is dissatisfied with the direction issued by the Commissioner General of Inland Revenue may appeal against such direction within thirty days of such direction. The decision of the Commissioner General on such appeal is final. However, the Commissioner General shall issue an assessment if the employee makes a request in writing on that behalf, to enable him to take up the dispute in appeal before the appropriate appellate tribunals as provided under the provision of the tax law. S. 101(4).

7. Refund of Tax Paid in Excess under PAYE.

Where any person has paid income tax by deudction in excess of the amount which he was liable to pay, such person is entitled to the refund of the excess tax paid on a claim made in writing within three years of the end of that year ot assessment. S. 149.

8. Deductions of Tax by Employer.

Every employer is required to deduct the correct amount of the tax due. However, there may be cases of over deduction and under deduction of income tax from the remuneration paid to employees.

Over deduction of Tax

Where an employer has deducted tax in excess from his employees, he cannot refund that tax to the employee. He cannot also set off any excess tax deducted from the employee against future payments. In such circumstances the employee can require a direction be issued so that future deduction can be adjusted.

Where an employer has remitted an amount of tax is excess of the amount due, may set off the excess against future payments. Where no set off is possible he may apply for a refund, of the tax paid in excess. A claim for refund must be made within three years of the end of the year of assessment. S. 149(5).

9. Failure to deduct income tax from Employee.

Where any employer fails to deduct income tax from the remuneration of any employee or where the employer had deducted income tax and has not remitted the full amount of such deduction to the Commissioner General he shall be personally liable for the entire amount of the tax he was required to deduct. Any tax which was deducted and not remitted to the Commissioner General on or before the 15th day of the month following the deduction shall be deemed to be in default.

The Commissioner General may recover from the employer the amount of the income tax or part thereof which an employer has failed to deduct S. 107(2). The Commissioner General is not prevented from recovery of the amount of income tax wholly from the employer or wholly from the employee or partly from the employer and partly from the employee. S. 107(3).

Where an employer has not deducted income tax in full from an employee's remuneration the employee shall give notice to the Commissioner General within fifteen days of the receipt of the remuneration giving full details of his name, address and remuneration. S. 105(1).

10. Credit for PAYE Tax. S. 111.

Where the assessable income of an employee for any year of assessment includes any remuneration in respect of which income tax has been deducted he shall be entitled to a set off against the tax payable for that year of assessment of the amount of the tax deducted on the production of a Certificate of deduction.

11. Penalty for default of PAYE by Employer. S. 110.

Where an employer fails to deduct income tax from the remuneration of an employee or has deducted and has not remitted the entire amount or part of the amount such amount shall be deemed to be in default from the 15th of the month following the pay period. Where income tax is deemed to be in default, such employer is liable to pay a penalty of:

(a) a sum quivalent to ten percent of such tax; and

(b) where such tax has not been paid within six months of the date of default, a further penalty of 15%

The Commissioner General may waive or reduce the amount of the penalty if he is satisfied that the failure to pay was due to circumstances beyond his control and that he has paid the amount of the tax and has furnished the declaration required to be furnished at the time of payment. S. 110.

12. **Issue of Assessment on the Employer**. S. 108.

An Assessor is empowered to issue an assessment on an employer at any time during the year of assessment within which that pay period falls or within three years from the end of that year of assessment in the following circumstances in which an employer:

(a) has failed to deduct the whole or any part of the income tax for any pay period; or

(b) has failed to remit to the Commissioner General the whole or any part of the income tax deducted for any period; or

(c) fails to furnish any monthly or the annual declaration; or

(d) has been assessed at an amount less than the proper amount of income tax, such employer should have deducted and paid to the Commissioner General.

An employer, who is assessed may appeal against such assessment within thirty days after the date of the notice of such assessment. The income assessed is payable notwithstanding that the employer has appealed against such assessment.

Income tax paid by an employer on an assessment made on him cannot be refunded. S. 149(5). However, where the employer is successful in his appeal, he will be entitled to have any sum paid on the assessment refunded to him.

13. **Marginal Cases**.

Where the income from the employment of an employee exceeds Rs. 12,000 and no tax has been deducted an anuual Tax Table No. 5 has been provided. In marginal cases regular profits may be less than Rs. 12,000 and the application of tax table for regular profit is not possible. When such employee receives any lump sum payment his total income may exceed Rs. 12,000 and the annual tax deduction table can be used.

14. **Non-resident Employees**.

PAYE system will apply to a non-resident employee who is in receipt. of employment income exceeding Rs. 1,000 per annum or Rs. 85 per month. S. 99(6). Where the employee is a British subject or a resident in a country which grants reciprocal relief, he will be entitled to double tax relief. The relief will be computed by reference to the tax he would have paid in respect of his total income if he were treated as a resident of Sri Lanka. Tax Table No. 4 will be applied in computing the amount of the income tax due.

Chapter 28

DEDUCTION OF TAX AT SOURCE

Where a person in Sri Lanka pays or credits to any person or partnership out of Sri Lanka any sum falling due as:-

(a) Interest on debentures, mortgages, loans, deposits or advances; or,

(b) rent, ground rent, royalty or annuity which is payable either in respect of property in Sri Lanka or out of income arising in Sri Lanka.

is entitled to deduct income tax at $33\frac{1}{3}\%$ or at such rates the Commissioner General of Inland Revenue may direct. S. 81(1). The amount of the tax deducted is a debt due from that person to the Government of Sri Lanka and is recoverable forthwith and can be assessed or charged upon such person. The person making the payment is liable to pay the tax deductible to the Commissioner General of Inland Revenue whether a deduction has been made by him or not.

The Commissioner General may prescribe any other rate of tax, other than $33\frac{1}{3}\%$, having regard to the total tax payable by that person for any year of assessment. S. 81(1) Proviso (a).

Tax is not deductible where the person in Sri Lanka pays another person in Sri Lanka, who is an agent of the person out of Sri Lanka. However, when such agent remits the money, he is entitled to deduct tax on such payment and is liable to pay the Commissioner General such tax.

No deduction of tax is necessary where;

(a) the interest is paid out of income not arising in Sri Lanka; or

(b) the interest on any loan or advance payable to a banker. S. 81(1)(I) Proviso (b);

(c) interest paid by foreign currency banking unit.[1]

1. Person in Sri Lanka and Person out of Sri Lanka.

Whether a person is in Sri Lanka or out of Sri Lanka will be determined on the basis of the destination of the payment. A person in Sri Lanka is an individual who is making the payment. A person out of Sri Lanka is the person who receives the payment outside Sri Lanka.

1. 24 of 1980.

2. **Obligation of the person deducting the tax.**

A person who is making a payment to a person out of Sri Lanka is entitled to deduct tax at the appropriate rate. S. 81(1). The amount deducted by him is payable forthwith to the Commissioner General of Inland Revenue.

3. **Issue of certificate of deduction.** S. 81(2).

A person deducting tax from any sum paid or credited to a person or a partnership out of Sri Lanka must issue to such person or partnership a statement in writing showing:

(a) the gross amount of such payment or credit;

(b) the rate and amount of tax so deducted ; and

(c) the net amount actually paid or credited.

4. **Set off of tax deducted.** S. 81(3).

Where the assessable income of a person includes a sum from which income tax has been deducted he is entitled to a set off against the tax payable by him of the amount shown as deducted in the statement issued to him.

Where, however, the amount of the tax deducted as shown in the statement exceeds the amount of tax payable by him, he will be entitled to a repayment of the excess. The claim for such refund must be made by the taxpayer within three years of the end of the year of assessment in respect of which such refund is due. S. 149(1).

5. **Rate of tax.** S. 81(2).

The person making the payment is entitled to deduct tax at $33\frac{1}{3}\%$. However, the Commissioner General of Inland Revenue has the power to direct that tax be deducted at a higher rate. The Commissioner General has directed that the following rate of tax be applied in deducting tax on payment made out to non-resident persons in respect of the following:

(a) Non-Resident Individuals:

Interest	—	$33\frac{1}{3}\%$
Royalty	—	$33\frac{1}{3}\%$
Annuity	—	$33\frac{1}{3}\%$
Rent	—	$33\frac{1}{3}\%$

(b) Non-Resident Companies:

Interest	—	$33\frac{1}{3}\%$
Royalty	—	$333\frac{1}{3}\%$
Annuity	—	$33\frac{1}{3}\%$
Rent	—	58.33%

Dividends payable by a Quoted Public Company 5%[1]
Dividends payable by other Resident Company 25%[1]

6. **Payment of Interest, Royalty or Annuity made gross.**

Where a person remits the full amount falling due as interest royalty or annuity to a non-resident company without deduction under any agreement to that effect, the Commissioner General has directed that deduction shall be made at 195.08%.

1. 27 of 1982.

7. **Indemnity to persons deducting tax.**

A person deducting tax in respect of payments made to non-resident person is indemnified against any person whomsoever in respect of his retention of such assets and the payment of such amounts as tax.

8. **Royalties received by a non-resident person from a Company with which an agreement has been entered into by the Greater Colombo Economic Commssion.** S. 15(j).

Royalties received by a non-resident person from a Company with which an agreement has been entered into by the Greater Colombo Economic Commission is exempt from income tax under terms of the agreement.

Section 17 of the Greater Colombo Economic Commission law provides for the exemption of income tax on the remittance of royalties for a period of Five years from the date of commencement of commercial production. After the completion of the period of five years all remittances of royalties are liable to tax at 10%.

The deduction of tax on these remittances of royalties will therefore be governed by the above tax concessions.

9. **Deduction of income tax on payments made to foreign entertainers and artistes.** S. 81A.[1]

(a) **Liability of the person making the payment:**

Any person who makes a payment to another person who is not a citizen of Sri Lanka and who carries on or exercises the profession or vocation of entertainer or artist for services rendered by such artist or entertainer shall deduct tax at $33\frac{1}{3}$% of such payment. S. 81A(1)(b). Any person who fails to deduct income tax required to be deducted then such person is personally liable to pay the tax which he failed to deduct and can be recovered from such person. The person liable shall be:-

(a) if such person is an individual, such individual;

(b) if such person is a company or body of persons, the Secretary, Manager or other Principal Officer of the Company or Body of Persons. S. 81A(4).

A person who deducts income tax on a payment made to foreign entertainers or artistes shall issue a statement giving the following particulars:-

(a) Gross amount paid;
(b) Rate and amount of tax deducted;
(c) Net amount actually paid.

(b) **Person receiving the Payment**

A person carrying on or exercising the profession or vocation of an entertainer or artiste is liable to income tax on the profits and income computed in accordance with the law and practice prevailing. The expression "profession or vocation of entertainer or artiste" includes, the profession or vocation of actor, musician, athlete or acrobat. S. 81A(5). In computing the profits of such person, all outgoings and expenses incurred in earning the

1. 27 of 1982.

profits can be deducted from the payment received in computing the profits on which income tax is chargeable.

Where such person is liable to income tax on the profits computed in accordance with the law and practice, such person is entitled to deduct from the income tax payable, the amount of the tax deducted from the payment received. S. 81A(3)(a). Where such person is not liable to pay income tax for that year of assessment or the tax deducted exceeds the tax payable, he shall be entitled to a refund. The statement from the person making the payment shall be produced in support of the claim for set off of tax or refund. In the case of a refund the claim for refund must be made within three years of the end of the year of assessment in which such tax was deducted. S. 81A (3)(b).

Chapter 29

ADMINISTRATIVE MACHINERY OF ASSESSMENT

The machinery for the assessment and collection of Income Tax, Wealth Tax and Gifts Tax is operated through a scheme of self-assessment. The scheme of self-assessment imposes a duty upon every person chargeable with tax to make a self-assessment of income tax, wealth tax or gifts tax and pay such tax to the Commissioner General of Inland Revenue in four quarterly instalments. S. 97.

1. **Duty to furnish a return.**

Every person who is chargeable with Income Tax, Wealth Tax or Gifts Tax for any year of assessment should furnish a return in such form and containing such particulars as specified by the Commissioner General on or before the thirtieth of November immediately succeeding the end of the year of assessment. For example, the return of the year of assessment 1982/83 must be furnished on or before the 30th November, 1983. S. 92(1). Where an individual has a child such individual must furnish a return of income or wealth of such child.

A person who is not chargeable with tax is not required to furnish a return to the Assessor. However, an Assessor may require any person to furnish within a prescribed time limit a return of his income, wealth or gifts, including that of any child S. 92(2).

2. **Form of return and information.**

The return must be made in such form containing such particulars as may be specified by the Commissioner General.

3. **Fuller and further returns and information.**

An Assessor may require fuller and further return and information with regard to any matter which may be relevant for the assessment of income tax, wealth tax, or gifts tax, as often as is necessary. S. 92(3). In order to obtain full information the Assessor may require such person in writing to:

(a) produce for examination any deeds, plans, instruments, books, accounts, trade lists, stock lists, registers, cheques, paying-in slips, auditor's reports or other documents in his possession. S. 92(4)(a). He may, with the approval of the Deputy Commissioner retain these documents as long as necessary for the purpose of ascertaining the income, wealth or gifts. S. 92(7).

(b) attend in person or by an authorised representative to be examined with regard to his income, wealth or gifts.

4. **Penalty for failure to Comply with the requirement to furnish return.**

Where any person fails to comply with a notice in writing given to him by an Assessor to furnish a return of income, wealth or gifts of himself and his child, if he has a child, the Commissioner General may:

(a) Impose a penalty of a sum not exceeding one thousand rupees; and

(b) require such person,

(i) to pay such penalty;

(ii) to furnish such return within a specified time. S. 96(1).

The Commissioner General may, however, reduce or waive the penalty imposed by him if it is proved to his satisfaction that the failure to furnish the return was due to circumstances beyond his control and that after the penalty was imposed he has furnished such return. S. 96(2).

A person failing to comply with a notice in writing by the Assessor to furnish a return of income, wealth, or gifts which he was required to furnish, is guilty of an offence and shall on conviction, after a summary trial before a Magistrate, to a fine not exceeding two thousand rupees. S. 151. A person who has been imposed a penalty by the Commissioner General for failure to furnish a return shall not be liable to a prosecution for the offence before a Magistrate. S. 96(3).

5. **The making of an Assessment.**

An Assessor is empowered to issue an assessment or an additional assessment in the following circumstances:

(a) Where a person who is liable to tax for any year of assessment has not paid the tax or has paid an amount less than the proper amount which he ought to have paid, an Assessor may, assess the amount which in his judgment ought to have been paid. Such an assessment can be issued by the Assessor after the fifteenth day of November immediately succeeding that year of assessment. S. 115(1).

(b) Where the Assessor is of opinion that any person is about to leave Sri Lanka or that it is expedient to do so for the protection of revenue he may issue an assessment for any year of assessment prior to 15th November immediately succeeding that year of assessment. S. 115(1).

(c) Where the Assessor is of opinion that a person has been assessed to income tax, wealth tax, or gifts tax for any year of assessment less than the proper amount such person ought to have been assessed he may issue an additional assessment. S. 115(2).

(d) Where a person has not furnished a return of income, wealth, or gifts and the Assessor is of opinion that such person is liable to pay income tax, wealth tax or gifts tax. S. 115(4).

6. **Assessor to give reasons for rejecting the return,** S. 115(3).

Where a person has furnished a return of income, wealth or gifts, the Assessor may either accept the return or where he does not accept the return he may reject the return and estimate the amount of the assessable income, taxable wealth or taxable gifts and assess him accordingly.

Where the Assessor does not accept a return furnished by any person for any year of assessment and makes an assessment or an additional assessment he shall communicate to such person in writing, his reasons for not accepting the return.

Where an Assessor rejects a return of income, wealth or gifts, he is bound to give reasons for non-acceptance of the return without exception. The provision to give reason is mandatory. The break down of the provisions requiring the Assessor to communicate his reasons are –

"(a) There is first a decision made not to accept a return. This is indeed an important decision which could entail serious consequences for the assessee.

(b) There is next the requirement of making an estimate. This must necessarily be done, otherwise no tax could be collected and the State would suffer. There is no doubt that this is a mandatory provision. For the imposition of a tax this is a *sine qua non*. Without it an imposition of a tax will be illegal.

(c) The third is a requirment to communicate reasons for the non-acceptance of the return. This is a duty coupled to the power of making an estimate and taxing thereon. It is a direction of Parliament contained in its legislation requiring obedience of a kind. I have no doubt this provision is a mandatory one." – Samarakoon, Q.C., C.J. in *Ismail v. C.G.I.R.*, S.C. 22 of 1981.

The provision of the section imposes a duty to communicate the reasons but does not impose a time limit within which such reasons should be communicated. But the exercise of the process of assessment is not complete until the reasons for not accepting the return have been communicated. The Chief Justice observed that such communication must be made at or about the time the assessor sends his assessment on an estimated income and a later communication will defeat the remedial action intended by the provision.

"......When an assessor does not accept a return, it must mean that at the relevant point of time he has brought his mind to bear on the return and has come to a decision rejecting the return. Consequent to this rejection, the reasons must be communicated to the Assessee. The provision for the giving of reasons ...... is to ensure that in fact the new procedure would be followed. More particularly the communication of the reasons at the relevant time is the indication of its compliance. The new procedure would also have the effect of fixing the Assessor to a definite position and not give him latitude to chop and change thereafter. It was, therefore, essential that an Assessor who rejects a return should state his reasons and communicate them. His reasons must be communicated at or about the time he sends his assessment on an estimated income. Any later communication would defeat the remedial action intended."– Samarakoon Q.C., C.J.

7. **Estimated Assessment.**

An estimate means an 'approximate calculation based on probabilities' (Shorter Oxford Dictionary). An estimated assessment can be made where the Assessor is of opinion that a person has paid tax less than the proper amount with which he is chargeable by rejecting the return made by the taxpayer.

The Assessor is entitled to reject the returns where he honestly comes to the conclusion that he should not accept the return, but he must give his reasons in writing for not accepting such return. Where the return is rejected he can substitute a higher estimate of the profits according to his judgment and can make any random assessment.

"Where an assessee does not choose to submit accounts, or fails to make a true and full disclosure, or by fraud or wilful evasion endeavours to escape liability, so that the amount of his profits cannot be strictly determined, he cannot complain if a random assessment is made upon him by the Crown". *Macpherson & Co. v. Moore;* 6 TC 114.

It is immaterial whether the reasons given by the assessor for rejecting the return are adequate or inadequate.

"Whether these reasons were in fact adequate or inadequate is quite immaterial if the assessor honestly comes to the conclusion that he should not accept the ...... returns but should substitute estimates of his own.'

Viscount Simon in the case of *Gamini Bus Co. Ltd. v. C.I.T.* 1 CTC 435.

The burden lies on the taxpayer to disprove the correctness of the estimate and to establish a lower figure. Although the areas of dispute may revolve around the reasons of the Assessor for making the assessment, the onus of disproving the estimate will be on the taxpayer.

"...... where, owing to the unsatisfactory nature of the return made by the Assessee the Assessor does not accept the return and makes an estimated assessment, then, the burden is on the Assessee to show what his correct income is. If he fails to do this, the estimated assessment must be accepted. There is no hardship in this rule, because an honest assessee can easily discharge that onus by producing his correct accounts. It is the dishonest Assessee who will not be able to discharge the burden of showing that the Assessor's estimated assessment is excessive." – Dias J. in *Gamini Bus Co. Ltd. v. C.I.T.* at page 423.

The bounds within which an Assessor may exercise his discretion in estimating the amount of the profits which according to his judgment ought to be assessed was examined in the case of *Gurmuk Singh v. C.I.T.;* 1944 A.I.R. 31 Lahore 361 – Indian Case.

(a) the Assessor is not bound to rely on evidence produced by the Assessee which the Assessor considers to be false;

(b) if the Assessor proposes to make an estimated assessment in disregard of the evidence, oral or documentary, produced by the Assessee, he should in fairness disclose to the latter the material on which he is going to found his assessment;

(c) an Assessor is not however debarred from relying on private sources of information, which sources he may not disclose to the Assessee at all.

(d) in such cases it is the duty of the Assessor to communicate to the Assessee the substance of the information so proposed to be utilised to such an extent as to put the Assessee in possession of full particulars of the case he is expected to meet and should give him ample opportunity to meet it if possible.

The bounds within which an Assessor may reject and substitute an assessment on the basis of his judgment can be seen in the judgment of Viscount Simon in the case of *Gamini Bus Co. Ltd. v. C.I.T.* at page 436. He said:

"Their Lordships cannot consider this part of their judgment without emphasising in the plainest terms that it would be wholly improper to justify the rejection of the appellant's accounts and the substitution of a higher figure of assessment merely because, in the case of the other tax-payers in the same line of business, the conclusion has been reached that their accounts were not accurately kept, and that their return required to be rejected. Each taxpayer is entitled to have his assessment fixed, if his own return is not accepted, at a figure which the taxing authorities honestly believe to be proper in his individual case, and no argument that in the class of business the figure of return is habitually understated can be used to prove that this happened in his also."

8. **Exercise of judment in estimating.**

The discretion with which an Assessor is vested in making an estimated assessment is a wide one. The Courts will uphold assessment made with due regard to principles of justice and fair play.

"No doubt Assessors, in view of the amplitude of the discretion vested in them under section 69 and the far reaching consequences of additional assessments which they make, will have prominently before them the principles of justice and fair play which must ever underline the exercise of such wide a discretion ...... As has been observed in regard to additional assessment under the English Acts, legal evidence is not necessary as a preliminary to an additional assessment but there must be information before the inspector 'which would enable him, acting honestly, to come to the conclusion' that such a state of fact exist"

Weeramantry J. in the case of *Jayanetti v. Mitrasena;* 3 CTC at page 337. He further said that an Assessor is not bound to base his assessment on provable facts.

"When making an assessment an Assessor is not bound to base his computations only on provable sources of income and is entitled to make an assessment according to his judgment. The burden then would shift to the Assessee to displace this assessment on the basis of facts which are peculiarily within his own knowledge. Indeed the language of (section 69) states no less, for it entitles the Assessor to make an assessment 'at the amount or additional amount at which according to his judgment such person ought to have been assessed."

9. Serving the notice of assessment. S. 143(1).

A notice of assessment may be served on a person either personally or by registered letter sent through the post to his last known place of abode or any place at which he is, or was during the year to which this notice relates carrying on business. S. 143(2).

A notice sent by post shall be deemed to have been served on the day succeeding the day in which it would have been received in the ordinary course of post. S. 143(3).

10. The form and validity of an assessment.

Any assessment issued cannot be invalid or deemed to be void or voidable for want of form or affected by reason of a mistake, defect or omission therein, if the same is in substance and effect in conformity with or according to the intent and meaning of the Inland Revenue Act, and if the person assessed or intended to be assessed or affected thereby is designated therein according to the common intent and understanding. S. 144(1).

The assessment cannot be impunged or affected by:

(a) reason of a mistake therein as to the name or surname of the person chargeable, the amount of the income, wealth or gifts assessed or the amount of the tax charged; or

(b) by reason of any variance between the assessment and the notice thereon;

if notice of such assessment is duly served on the person intended to be charged and contains in substance and effect the particulars mentioned in paragraph (a).

11. Time limit for making assessment.

An Assessor is prescribed from making an assessment or an additional assessment after the expiry of three years from the end of the year of assessment in respect of which assessment is being made. S. 115(5). For example, an Assessor cannot issue any assessment or an additional assessment in respect of the year of assessment 1982/83 after 31.03.1986.

An assessment in respect of income tax, wealth tax or gifts tax cannot be made on or before the 15th November following the relevant year of assessment unless the Assessor is of opinion that a person is about to leave Sri Lanka or it is necessary for the protection of revenue.

An Assessor is not prevented from making an assessment or additional assessment at any time after the end of that year of assessment if the non-assessment or under-assessment is due to fraud or wilful evasion. There is no time limit for assessment of arrears of salary received by any person in respect of a previous year of assessment.[1]

Where an assessment for any year of assessment has been determined on appeal, the assessment determined on appeal is final and conclusive as regards the assessable income, taxable wealth or gifts. S. 123. However an Assessor is not prevented from making an assessment or additional assessment which does not involve reopening any matter which has been determined on appeal for that year.

1. 24 of 1980.

12. **Fraud or wilful evasion.**

An Assessor can make an assessment or an additional assessment at any time where the non-assessment or under-assessment is due to fraud or wilful evasion.

Fraud implies intention to deceive and can be proved where it is shown that a false representation has been made:

(a) knowingly; or

(b) without belief in its truth; or

(c) recklessly or carelessly whether it is true or false.

To found an assessment the taxpayer must have unlawfully escaped or avoided by fraud, misrepresentation or underhand contravention his liability to tax. The assessment can be sustained only where the omission is made wilfully and deliberately with the evil intention of defeating unlawfully the object of the statute by knowingly presenting a false picture of the income, wealth or gifts of the person making the return by omitting therefrom material which the taxpayer knows should be there: *Chellappa v. C.I.T.* 1 CTC 382.

13. **Finality of an Assessment.** S. 123.

An Assessment issued on a taxpayer is final and conclusive in the following circumstances:

(i) where no valid appeal has been lodged within thirty days after the date of the notice of assessment as regards the amount of the assessable income or the taxable wealth or taxable gifts assessed thereby; or

(ii) where an appeal against an assessment is dismissed by the Commissioner General on the failure of the appellant or his authorised representative to attend in person at the hearing of the appeal or fails to attend the hearing of the appeal when required to do so by the Commissioner General of Inland Revenue; or

(iii) where adjustment to an assessment has been made on matters specified in the petition of appeal on an agreement reached between the Assessor and the appellant as to the amount of assessable income or taxable wealth or taxable gifts; or

(iv) where the amount of the assessable income or taxable wealth or taxable gifts has been determined on appeal.

Although the assessment is final and conclusive under the above circumstances an Assessor is not prevented from making an additional assessment which does not involve reopening any matter which has been determined on appeal. The term determined on appeal means decided by an authority adjudicating in the matter and does not apply to the adjustment made by an Assessor by agreement with the taxpayer. *C.I.T. v. Saverimuttu Reddy;* 1 CTC 416.

Chapter 30

APPEALS

Disputes regarding assessments would generally arise when the Assessor makes an assessment of a greater amount of profits or income than that as shown by the taxpayer. Disputes in an appeal can be in the form of:-

(a) disputes with regard to facts;

(b) disputes with regard to mixed question of fact and of law;

(c) disputes with regard to the interpretation of law

The final appellate Tribunal with regard to disputes of facts is the Board of Review. S. 122(1). The Supreme Court is bound by the findings of the Board of Review on a question of fact as long as there appears to be evidence to support it: *Dias v. C.I.T.* 1 CTC 270. Disputes with regard to the question of law can be taken with the Court of Appeal and the Supreme Court.

Any person who is aggrieved by an amount of an assessment or by the amount of any valuation has the right to appeal against the assessment to the Commissioner General within thirty days of the notice of assessment. S. 117 (1). Unless an appeal is made under these provisions, the assessment will be final and conclusive and the taxpayer will loose the remedy provided in the law. Thus when an assessment is received, the taxpayer. if he has any doubts, should give a protective notice of appeal so that the machinery provided for disputing the assessment can be availed off.

The taxpayer must consider when deciding to take any disputes in appeal the cost and the time involved in arriving at a settlement.

1. Notice of Appeal

Every notice of appeal shall conform to the following conditions:

(a) the appeal must be in writing addressed to the Commissioner General. S. 117(2).

(b) the appeal must be made within thirty days after the notice of assessment. S. 117(1).

(c) the letter of appeal must state precisely the ground of appeal. S. 117(2).

(d) where the appeal is against an estimated assessment made in the absence of the return, the petition of appeal must be sent together with the return. S. 117(3).

If any of the conditions stated above has not been satisfied, the appeal will not be valid. S. 117(4); and where the taxpayer fails to state precisely his grounds of objection against the assessment but merely lodges an "emphatic protest", such protest is not a notice of appeal. *J. A .Baharan v. D. G. Obesekera.* 1 CTC .500.

The ground of appeal can be stated in general terms e.g. that the assessment is excessive, that the assessment is not in accordance with the return and accounts of the business, or is erroneous in law, as to keep an assessment open so that any novel point of law or fresh facts can be put forward.

A notice of assessment sent by post is deemed to have been served on the day succeeding the day on which it would have been received in the ordinary course by post. S. 143(3). Thus in determining the thirty days limit, a grace of three days can be claimed.

2. Late Appeal

The Commissioner General on being satisfied that a person has been prevented from appealing within the prescribed time owing to:

(a) absence from Sri Lanka;

(b) sickness; or

(c) other reasonable cause;

shall grant an extension of time for preferring the appeal. S. 117(1). A person who has not appealed within the prescribed time limit due to any of these reasons, should make an application, giving the circumstances with whatever evidence, for the admission of a late appeal.

3. Tax in dispute.

The full tax on the assessment which is under appeal is payable on the date, unless the Commissioner General orders that the payment of the tax be held over pending the settlement of the appeal. S. 125(4). Where the Commissioner General considers that any tax which has been held over is likely to become irrecoverable or that the tax payer is unreasonably delaying the prosecution of the appeal, he may revoke the order and require the tax to be paid on a specified date. S. 125(5).

Where the dispute is confined to a particular point while all other aspects of the assessments have been agreed, the tax that is not in dispute can be calculated and paid by agreement with the Revenue. The revenue will not normally insist on the payment of tax which is in dispute, unless it is considered that the appeal is on frivolous grounds.

The discretion to hold over the tax in dispute is entirely with the Commissioner General and the taxpayer cannot request hold over of tax in dispute as a right.

4. Withdrawal of Appeal.

Once the taxpayer has appealed against the assessment, he cannot thereafter withdraw or abandon the appeal unless an agreement to that effect has been reached. Lord Hewart commenting on a writ of probihition which an appellant sought to prevent the hearing of the appeal which he wished to withdraw, said.

"The matter has passed out of his hands after he has given the notice of appeal. By that notice he gives to the Commissioners not only the opportunity, but also the duty, of performing a public task, which may have a result of a character entirely opposite to that which he anticipated when he gave the notice of appeal." *R. v. Income Tax Special Commissioners exparte,* Elmhirst 20 TC 384.

An appeal once made can only be withdrawn by agreement with the Assessor.

5. **The onus of proof**

The burden of proving that the assessment is excessive or erroneous lies with the taxpayer. S. 121(5). "Once the assessment has been made, whether it is one made on a return furnished by the Assessee, or an estimated assessment made by the Assessor under the powers vested in him, there arises a rebutable presumption that the official act of assessment has been rightly and regularly performed. Therefore, when an Assessee appeals against such an assessment, the onus of displacing the assessment rests on him, and it is for the Assessee to begin to satisfy the Commissioner General that the assessment is wrong and is excessive." *Guillain v. C.I.T.* 1 CTC 361.

Not only the onus lies on the taxpayer but the facts which would enable the Commissioner to reduce or set aside the assessment or the additional assessment, were facts which are peculiarly within the taxpayers knowledge. Where the taxpayer fails to produce material evidence which would be of great value for the purpose of forming the Assessors opinion, the Assessor is entitled to make an assessment according to his judgment. It is, therefore, necesssary for the taxpayer to produce sufficient evidence to support the contention that the assessment is excessive. The question to the Assessor or the Commissioner General, is one of fact and peculiarly one for the application of their business knowledge and common sense.

Properly prepared accounts are *prima facie* evidence of the correctness of the figures of the assessable profits which they support unless it is proved that the accounts are unreliable. An account made by an accountant convicted of perjury was considered unreliable – *Tudor and Onions v. Drucker;* 8 TC 591. The requirement of an audited accounts may be overlooked in small cases but the Commissioner General may insist on an audited accounts. The refusal to accept as evidence accounts which were not duly certified was upheld as a decision of fact and that no error in law arose. *Hunt & Co. v. Jolly;* 14 TC 165; *Wall v. Cooper;* 14 TC 552.

6. **Question of fact and of law.**

The final appellate Tribunal on question of fact rests with the Board of Review. The Supreme Court is bound by the finding of the Board of Review on a question of fact as long as there appears to be evidence to support it. *Dias v. C.I.T.* 1 CTC 270. At the stage of proceeding on appeal before the Commissioner General, the taxpayer must furnish all the evidence available at his disposal to set aside the assessment, as especially, any evidence which has not been placed before the Commissioner General will not be admissible evidence before the Board of Review except with their consent.

It is difficult to define the precise definition between a question of fact and one of law. This is of great importance as the courts will not interfere with the decision of the Board of Review which it considers to be a question of fact. Where the dispute involves the interpretation of a statute or the application of legal principles, the question is one of law. Where the inference to be drawn is from a course of activity, the question will be one of fact.

Where the Board of Review state the evidence before them and hold that certain results follow, then it is open to Court to review whether there is evidence to support the conclusion.

> "It is undoubtedly, true that if the Commissioners find a fact, it is not open to this Court to question that finding unless there is no evidence to support it. If, however, the Commissioners state the evidence before them, and add that upon such evidence they hold that certain results follow, I think it is open, and was intended by the Commissioners to be open, to the Courts to say whether the evidence justified what the Commissioners held". *Gramophone & Typewriter Ltd. v. Stanly.* 5 TC 358.

Further, Lord Porter in *Fattorini v. I.R.C. Case,* 24 TC 344–

> "The final conclusion (of the Commissioners) is not a fact, but an inference upon facts previously set out, and ...... the conclusions upon the tribunal unless it appears from the previous findings that there are facts to support it".

7. **Mixed question of fact and law.**

There are, however, mixed questions of fact and of law and these are considered reviewable by the Courts. The concept of the mixed question of fact and law and the circumstances under which the Courts will interfere has been quoted by H. N. G. Fernando J. in *Mahavitana v. C.I.T.* 3 CTC 156 from an Indian Case of *Naidu v. C.I.T.* In that case, Gajendagadker J. stated the circumstances under which the Courts will interfere:

"(a) In pure questions of law, the Court is free to adopt such construction as is reasonable.

(b) If the findings of fact is on inference drawn from primary evidentiary facts proved in the case its validity is open to challenge. The challenge may be made that inference had been made considering inadmissible evidence or excluding admissible and relevant evidence. Then if the Court is satisfied that the inference is the improper admission or exclusion of evidence, it would be justified in examining the correctness of the conclusion.

(c) It is also open to challenge a conclusion drawn by the Tribunal on the ground that it is not supported by legal evidence or that the impunged conclusion drawn from the relevant facts is not possible and if this is established the Court can consider the question.

(d) The Revenue or the Assessee may seek to challenge the correctness of the conclusion on a mixed question of fact and law. Such conclusion is based on primary evidentiary fact but in ultimate form determined by the application of the legal principles. The need to apply the relevant legal principles tends to confer upon the final conclusion the character of a legal conclusion and that is why it is regarded as a conclusion on a question of mixed and fact. In dealing with the findings on a question of mixed law and fact the High Court will no doubt have to accept the findings of the Tribunal on the primary questions of fact; but it is open to the High Court to examine whether the Tribunal has applied the relevant legal principles correctly or not."

8. **Form and Substance.**

It is an established doctrine of the rules of interpretation that where a document or transaction is genuine the Courts cannot go behind it to examine any underlying substance. *I.R.C. v. Duke of Westminster* (1936) A.C. 1. A new approach has been established to this doctrine by the House of Lords that the Courts could examine the overall effect of an avoidance scheme or arrangement and cannot be compelled to examine each transaction separately but may collectively consider the component part of a single scheme or an arrangement. Thus in the case of *Ramsay v. C.I.R.* and *Rawlings v. C.I.R.* and *Rawlings v. Eilbeck* (1981) where an avoidance scheme of two separate transactions which sought to create an allowable loss in one transaction in order to offset a capital gain in the other transaction although in the final result the scheme did not involve in a little or no loss at all was held as artificial and fiscally ineffective.

"Given that a document or transaction is genuine, the Court cannot go behind it to some supposed underlying substance. This is the well known principle of *I.R.C. v. Duke of Westminster* (1936) A.C. 1. This is a cardinal principle but it must not be overstated or overextended. While obliging Court to accept documents or transactions, found to be genuine, as such, it does not compel the Court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a wider transaction intended as a whole there is nothing in the doctrine to prevent it being so regarded: to do so is not to prefer form to substance, or substance to form. It is the task of the Court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be so regarded." – Lord Wilberforce.

He reiterated further, that –

"While the techniques of tax avoidance progress and are technically improved the Courts are not obliged to stand still. Such immobility must result either in loss of tax, to the prejudice of other taxpayers, or to parliamentary congestion or (most likely) to both. To force the Courts to adopt in relation to closely integrated situations, a step by step, dissecting, approach which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process. In each case the facts must be established, and a legal analysis made."

"This case shows, in my opinion, that although separate steps were "genuine" and had to be accepted under the Westminster doctrine, the Court could, on the basis of the findings made and of its own anaylsis in law, consider the scheme as a whole and was not confined to a step by step examination."

Lord Fraser of Tullybiton ..

"The Counsel for the taxpayer naturally pressed upon us the view that if we were to refuse to have regard to the disposals which took place in the course of these schemes, we would be departing from a long line of authorities which required the Courts to regard the legal form and nature of transactions that have been carried out. My Lords, I do not believe that we would be doing any such thing. I am not suggesting that the legal form of any transaction should be disregarded in favour of its supposed substance. Nothing that I have said is in any way inconsistent with the decision in the *Duke of Westminister Case* (1936) A.C. 1. where there was only one transaction the grant of an annuity and there was no question of its having formed part of any larger scheme."

9. **Applicability of the decisions for subsequent years.**

Assessments made subsequent to the decision of the Appeal Tribunal will normally be on the basis of that decision as far as it involves questions of law which will be binding on similar cases. However, where there has been decisions on mixed question of fact and law will apply only to that assessment to which the decision relates.

In the case of *Abdul Gaffor v. C.I.T.* 3 CTC 96 the Privy Council held that in the matter of a recurring annual tax a decision on appeal with regard to one year cannot operate as *res judicata* in respect of an assessment for another year. Although the process of arriving at the necessary decision is likely to involve the consideration of question of law, all such questions have to be treated as collateral or incidental to one subject only, namely the amount of the assessable income for the year in which the assessment is challenged. The finality to a determination as regard the assessable income assessed thereby, that is to say, as regards the amount ot the income for that year to which the determination relates and not the income of the subsequent years.

10. **Appeal procedures.**

Appeal of taxpayers are taken up in the following stages:

(a) On receipt of a valid appeal the Commissioner General may cause further inquiry to be made by an Assessor as to matters raised in appeal and to reach an agreement and make necessary adjustment of the assessment. S. 117(5).

(b) Where no agreement has been reached between the Assessor and the appellant the Commissioner General will hear both the taxpayer and the Assessor and make his determination on the matters raised in appeal.

(c) Where the taxpayer is not satisfied with the determination of the Commissioner General, he may appeal to the Boardof Review. The Board of Review will them hear the appeal and give their decision on the matters raised in the appeal. The Commissioner General may also refer any valid appeal to the Board of Review for their determination.

(d) The appellant or the Commissioner General may require the Board of Review to state a case on a question of law for the opinion of the Court of Appeal.

(e) The appellant or the Commissioner General may then appeal to the Supreme Court against the determination of the Court of Appeal.

11. Appeal proceedings with the Assessor.

In practice, most of the appeals are normally settled by agreement with the Assessor at an informal discussion at which all the facts relating to the assessment will be discussed. The succeess of the appeal by the taxpayer will depend on the marshalling of the relevant evidence before the Assessor so as to convince him of the facts and the reasons why the assessment should be reduced or set aside. Where the taxpayer is not in a position to adduce sufficient documentary evidence, he will find it extremely difficult to pursue his appeal successfully. If there is evidence to prove that the assessment is excessive, the taxpayer can sustain the appeal, however speptical the attitude which the income tax authorities may adopt.

The assessment agreed with the assessor on an appeal is final and conclusive. However, the finality will not prevent an Assessor from making an assessment or an additional assessment for any year of assessment which does not involve the reopening of any matter determined on appeal. S. 123. The term determined on appeal means decided by an authority adjudicating in the matter and does not apply to the adjustment made by the Assessor by agreement with the taxpayer *C.I.T. v. Saverimuttu Reddy* 1 CTC 103. An agreement as to the amount of the assessable income reached between the Assessor and the taxpayer is a matter adjusted at that stage and is not determined on appeal.

An Assessor is not bound to observe strict rules of evidence in pursuing his inquiry on the appeal. The kind of evidence that an Assessor can make use of was considered in an Indian case *Gurmukh Singh v. C.I.T.* which was quoted by Dias C. J. in the case of *Gamini Bus Co. Ltd. v. C.I.T.* 1 CTC 416. The kind of evidence that an Assessor can make use of are:

(a) The Assessor is not bound to rely on evidence produced by the Assessee which the Assessor considers to be false;

(b) If the Assessor proposes to make an estimated assessment in disregard of the evidence, oral or documentary, produced by the Assessee, he should in fairness disclose to the latter the material on which he is going to found his assessment.

(c) The Assessor is not debarred from relying on private source of information, which sources he may not disclose to the Assessee at all.

(e) In such cases it is the duty of the Assessor to communicate to the Assessee the substance of the information so proposed to be utilised to such an extent as to put the Assessee in possession of full particulars of the case he is expected to meet, and should give him ample opportunity to meet it if possible."

Where the Assessor gives reasons for rejecting the return, the question whether the reasons are in fact adequate or inadequate is quite immaterial if the Assessor honestly came to the conclusion that he should not accept the return but should substitute an estimate of his own. *Gamini Bus Co. v. C.I.T.* 1 CTC 431.

In estimating the income the Assessor must apply his mind and his judgment truly to the figures of the relevant years, guessing them if necessary, to the best of his ability from the sources of information he has and from the best of his skill and judgment. Where the Assessee does not choose to submit his accounts or fails to make a true and full disclosure, so that the amount of the profit can be strictly determined, he cannot compalin if a random assessment is made upon him. *Macpherson & Co. v. Moore:* 6 TC 508.

Where no agreement on the matters arising on the appeal can be reached with the Assessor the taxpayer can require that the appeal be heard by the Commissioner General.

12. Appeal before the Commissioner General.

Where no agreement has been reached with the Assessor with regard to the matters raised by the taxpayer in appeal, the Commissioner General shall fix a time and place for the hearing of the appeal. S. 117(6). The Commissioner General may also refer any valid appeal to the Board of Review for determination. S. 120.

Every appellant must attend the hearing of the appeal before the Commissioner General either in person or by authorised representative. He may adjourn the hearing of the appeal and may if he considers that the personal attendance of the appellant is necessary for the determination of the appeal, require the appellant to attend the hearing in person. Where the appellant or his authorised representative fails to attend the hearing as required by the Commissioner General, he may dismiss the appeal. The Commissioner General may, however, vacate the order dismissing the appeal if he is satisfied that the appellant or his authorised representative was prevented from due attendance due to the reason of absence from Sri Lanka, sickness or other reasonable cause and fix a time and place for the hearing of the appeal. S. 117(7).

The Commissioner General has the power to summon any person whom he considers able to give evidence respecting the appeal to attend in person before him and may examine such person on oath or otherwise. Any person attending such hearing will be allowed reasonable expenses necessarily incurred by such person in so attending. S. 117(8).

The Commissioner General after the hearing of the appeal may confirm, reduce, increase or annul the assessment appealed against and shall give notice in writing to the appellant of his determination on the appeal. S. 117(11).

The Commissioner General may require any person before making his determination, if he considers it necessary, to transmit to him or produce for examination any deeds, plans, instruments, books, account, trade lists, registers, cheques, paying-in-slips, auditors' reports, or other documents in his possession, as are specified in that notice. S. 117(9).

13. Evidence and documents at the hearing of the Appeal by the Commissioner General.

The Commissioner General is not required to adhere to the strict rules of evidence in respect of the appeal proceedings. He is, however, required to maintain records of the evidence of the appellant and of any other person heard by him in respect of the appeal.

At the hearing of the appeal before the Board of Review an appellant is not allowed:-

(a) to produce any document which was not produced before the Commissioner General;

(b) to adduce the evidence of any witness whose evidence was not led before the Commissioner General;

(c) to adduce the evidence of any witness whose evidence has not been recorded at the hearing before the Commissioner General;

without the consent of the Board of Review and on such terms decided by the Board. S. 121(8). In view of this requirement it is necessary that all the documents and evidence necessary for the appeal must be led and recorded at the hearing of the appeal before the Commissioner General.

14. Appeal to the Board of Review.

An appellant or his authorised representative who is dissatisfied with the determination of the Commissioner General on the appeal may communicate in writing to the Commissioner General his dissatisfaction with the determination. S. 119(1). The Commissioner General shall transmit within one month of such notice of dissatisfaction of his determination, his reason for that determination. S. 119(2).

The appellant or his authorised representative may within one month of the transmission of the reasons for the determination, appeal in writing to the Board of Review. Such petition of appeal must conform to the following conditions:-

(a) be accompanied by a copy of the determination of the Commissioner General against which the appeal is made;

(b) set out precisely the grounds of appeal therefrom;

(c) be delivered to the Clerk to the Board of Review.

The Commissioner General may also refer any valid appeal made to him to the Board of Review and the Board of Review shall hear and determine such appeals. S. 120.

15. The Board of Review.

The members of the Board of Review are more like independent arbitrators which the legislature has thought it right to appoint as an administrative check in favour of the taxpayer and as an additional assurance that his liability to tax will be correctly ascertained – *D. J. Ranaweera v. C.I.T.* 2 CTC 395. The essence of the function of the Board is that they remain independent and impartial.

The Board of Review does not exercise judicial power but it is one of the instruments created for the administration of Income Tax Act and that as such its work is administrative though judicial qualities are called for in its performance.

16. **Hearing of the Appeal.** S. 121.

The appeal before the Board of Review will be heard in camera. 121(6). The Clerk to the Board of Review will fix the time and place of the hearing and shall give fourteen days notice to the Appellant and the Commissioner General. The appellant must attend the meeting of the Board in person or by his authorised representative. The Assessor who made the assessment or other person authorised by the Commissioner General will attend the meeting of the Board to support the assessment. The onus of proving the assessment is excessive or erroneous is on the appellant. The Board may postpone the hearing as long as is necessary to enable the attendance in person of the appellant.

17. **Transmission of documents by the Commissioner General to the Board of Review.** S. 121(2).

The Commissioner General shall on receipt of a notice from the Clerk to the Board of Review as regard the time and the place of the hearing of the appeal transmit to the Board a copy of the record of evidence maintained by him.

18. **Evidence before the Board of Review.** S. 121(7) & (8).

The Board has the power to summon any person to attend the hearing and give evidence respecting the appeal and examine him as a witness whether on oath or otherwise.

The appellant will not be allowed without the consent of the Board and on such terms as the Board may determine to:-

(a) produce any document which was not produced before the Commissioner General; or

(b) to adduce the evidence of any witnessess whose evidence was not led before the Commissioner General at the hearing;

(c) to adduce the evidence of any witness whose evidence which has not been recorded at the hearing before the Commissioner General.

19. **Admission of Evidence.**

The Board of Review has the power to admit or reject any oral or documentary evidence adduced. The provisions of the Evidence Ordinance relating to the admissibility of evidence shall not apply to the Board of Review. S. 121(9).

"Where the return of the Assessee is open to suspicion and where estimated assessment, therefore, has to be made, the legislature did not intend that the proceedings before the Commissioner of Income Tax should be governed by the strict rules of evidence observed in a Court of law. Provided, the proceeding adopted is fair and in accordance with principles of fairplay and natural justice the document ...... will be admissible" Dias C.J. in *Gamini Bus Co. Ltd. v. C.T.I.* 1 CTC 416.

In the case of *Guillain v. C.I.T.* 1 CTC 361 a certain document was produced but was not marked as a document and no complaint was made about this matter in the petition of appeal to the Board of Review. The Board did not allow fresh evidence led at this stage and did not give permission to mark these documents at that stage. In these circumstances the Court held that there has been no failure to consider evidence which was properly admissible. When a document is admitted *inter partes* and without objection from the Assessee or his legal advisors no objection can be taken to the admission of the document at a later stage.

The business instruments of the appellant were not conclusive evidence of the transaction recorded therein but could be contradicted by parol evidence. *Hakim Bai v. C.I.T.* 1 CTC 8.

An opinion about the intendment of the contract may be received in evidence but they are not in law admissible as aids to the construction of the contract. The language of section 73 (7) IRA s. 121 (9) is very wide, but it does not go so far as to authorise the Board to ignore the rule that construction is a matter of law and not of evidence. *C.I.T. v. Mrs. Sutherland* 1 CTC 403.

20. **Question of fact.**

The final appellate tribunal with regard to question of fact is the Board of Review. S. 122(1). The Courts will not interfere with a decision of the Board of Review on a question of fact as long as there appears to be evidence to support it.

> "It is fundamental matter that all questions of fact are for the authority whether the Commissioner of Income Tax or the Board of Review, who is charged with the matter and this Court can interfere only if there is an error of law–it being, of course, an error of law if a finding of fact is arrived at with no evidence to support it. It is not an error of law to arrive at a finding of fact whether there is so to speak evidence both ways."

Dias C. J. in *Guillain v. C.I.T.* 1 CTC 361, quoting from the case of *Montague Burton & Co. v. C.I.R.* 28 TC 58.

Examples of question of fact and law.

1. The question whether the Ceylon Branch carried on the business of Banking at the relevant time is a question of mixed fact and law; *Bank of Chettinad v. C.I.T.* 1 CTC 409.
2. The question whether there was a reasonable probability of a certain sum of money in the cash account of the company being required for the business of the company is a question of fact for the Board of Review to decide and is strictly not a question of law. *C.I.T. v. Glasgow Estates Co. Ltd. v.* 1 CTC 538

In *Edwards v. Bairstow and Harrison* 36 TC 207 the House of Lords held that the Courts may reverse a pure finding of fact if there is no evidence to support the determintation or the only reasonable construction of that evidence could not support the findings reached.

It is universally conceded that though it is a pure finding of fact it may be set aside on grounds which have been stated in various ways

I think, fairly summarised by saying that the Court should take that course if it appears that the Commissioners have acted without any evidence or upon a view of the facts which could not reasonably be entertained."— Viscount Simonds 36 TC 207.

"It may be that the facts found are such that no person acting judicially and properly instructed as to the relevant law would have come to the determination under appeal. In those circumstances, too, the Court must intervene. It has no option but to assume that there has been some misconception of the law, and that this has been responsible for the determination. So there, too, there has been error in point of law. I do not think that it much matters whether this state of affairs is described as one in which the evidence to support the determination or is one in which the evidence is inconsistent with and contradictory of the determination, or is one in which the true and only reasonable conclusions contradicts the determination." — Lord Radcliff, 36 TC 207.

It should therefore be noted that when proceeding in appeal facts must be carefully prepared and presented. Where the finding of the Board of Review on pure questions of fact is found to be unreasonable, the Courts may set aside their findings

In *Tyrer v. Smart* Lord Fraser in the House of Lords:—

"At the end of the hearing of this appeal, I was inclined to dismiss it on the ground that the conclusions of the Special Commissioners were unreasonable in the sense explained by Lord Radcliff in *Edwards v. Bairstow*. But further reflection ...... has convinced me that even though Special Commissioners conclusion is one that many judges may disagree with, it cannot properly be described as unreasonable. It is therefore, not one that I am entitled to interfere with."

21. Decision of the Board.

After hearing of the appeal the Board shall confirm, reduce, increase or annul the assessment as determined by the Commissioner on appeal or as referred to the Board for decision. The Board can also remit the case back to the Commissioner General with their opinion, and the Commissioner shall revise the assessment accordingly. The decision of the Board shall be notified to the appellant and the Commissioner General in writing. S. 121(10).

Where the Board does not reduce or annul the assessment, the Board may order the appellant to pay a sum not exceeding five hundred rupees as costs of the Board. S. 121(11).

The Commissioner General or the Appellant may, if they disagree with the decision of the Board, require the Board to state a case for the opinion of the Court of Appeal, within one month of the decision of the Board. The Board will thereupon state a case for the opinion of the Court of Appeal, setting forth the facts, the decision of the Board and the amount of the tax in dispute. An application to state a case will not be entertained unless it is made in writing and delivered to the Clerk to the Board together with a fee of fifty rupees within one month of the date of the decision of the Board.

22. **Case stated**

The function of the Board is to set forth fully, with care and attention, the facts and the decision of the Board. The Board should not state abstract questions of law or hypothetical questions in a catechistic form. The case stated must contain all relevant facts contained in each material document; where the question arising on the case is the interpretation of the document, the document itself should be part of the case. *R. M. Fernando v. C.I.T.* 1 CTC 576.

Where there is no tax in dispute, the question of law is one of pure academic interest. In such cases the assessee has no right of appeal and it is not open to the Board of Review to state a case on a question of law for the opinion of the Supreme Court; *Navaratnam v, C.I.T.* 1 CTC 378.

A case stated, should contain in addition to the statement of facts expressly formulated questions of law for the decision of the Supreme Court. The points arising in the case stated should be embodied in the case stated by the Board so as to enable the Court of Appeal to adjudicate on them.

23. **Appeal to the Court of Appeal**

The appellant or the Commissioner General may, if they are not satisfied with the decision of the Board Review, transmit to the Court of Appeal, the case stated within fourteen days of the receipt of the case stated. The proceeding before the Court of Appeal is deemed to be a civil proceeding of the value of five thousand rupees or such greater amount as set forth by the Board, as the tax in dispute. The case stated together with all books, documents and papers annexed thereto will form one exhibition in civil proceedings before the Court of Appeal.

At or before the time when the appellant transmits the case stated to the Supreme Court, the party requiring it shall send to the other party by notice in writing of the fact that the case has been stated and supply him with a copy. The word "at or before time", though they might possibly give some latitude, certainly do not permit a delay of some five weeks in complying with this provision. *Cosmas v. C.I.T.* 1 CTC 118. However, the delay of two days in giving notice of the case stated did not deprive the Court of Appeal of jurisdiction to hear the case. *Wickramasinghe v. C.I.T.* 1 CTC 329.

Any two or more Judges of the Court of Appeal may cause a stated case to be sent back to the Board for amendment and thereupon the Board shall amend the case accordingly.

Any two or more Judges of the Court of Appeal shall hear and determine any question of law arising on the stated case and in accordance with the decision of the Court upon such question confirm, reduce, increase, or annul the assessment determined by the Board. The Court may also remit the case to the Board with the opinion of the Court and the Board shall revise the assessment as the opinion of the Court may require. The questions the Court will consider will only be;

(a) questions of law;

(b) questions of mixed law and fact;

(c) questions where there is no evidence to support the decision of the Board of Review on a question of fact.

Any party who wishes to take up the appeal before the Supreme Court may do so from the order of the Court of Appeal. The decision of the Supreme Court shall be final between the Commissioner General and the taxpayer. Section 128(1) of the Constitution of the Democratic Socialist Republic of Sri Lanka provides that an appeal shall lie to the Supreme Court from any order of the Court of Appeal which involves a substantial question of law if the Court of Appeal grants leave to appeal to the Supreme Court.

Chapter 31

REPAYMENT OF TAX PAID IN EXCESS

Taxpayers are entitled to repayment of tax paid in excess under the following circumstances:-

(a) Where any person has paid any income tax, wealth tax or gifts tax by deduction or otherwise in excess of the amount which he was liable to pay for that year of assessment by a claim made in writing within three years of the end of a year of assessment. S. 149(1).

(b) Where the taxpayer can prove to the satisfaction of the Commissioner General of Inland Revenue by a claim made in writing within three years of the end of a year of assessment that he has paid income tax, wealth tax or gifts tax in excess due to an error in the assessment or the return of the income. S. 149(3).

(c) Where an employer has paid any sum in excess of the amount which he should have paid for that year of assessment and a claim for refund is made within three years of the end of the year of assessment. S. 149(5).

(d) Where tax has been paid in excess which arose on the set-off of capital loss at death. S. 29(6)(d)(ii).

(e) Where a company is liquidated and tax is found to have been paid in excess when any capital loss has been deducted. S. 29 (6)(iv).[1]

(f) Where tax has been paid in excess which arose on the revision of assessment which included interest receivable, which subsequently was found to have been irrecoverable. S. 23(4).

(g) Where tax has been paid in excess on the revision of the assessment in which the Assessor refused deduction of annuity, ground rent, royalty or interest payable was found to have been subsequently paid. S. 29(2)(a)(iv).

(h) Where tax has been paid or deducted on profits and income not exceeding Rs. 1,200 of an employee who received profits from the employment not exceeding Rs. 30,000. S. 9(1)(l).[2]

(i) Where the rate of income tax applicable to interest of certain deposits is less than fifteen percent. S. 32B(2)(d).[2]

---

1. 40 of 1981. 2. 27 of 1982.

(j) Where tax deducted on payments received by foreign entertainers and artistes exceed the income tax payable by such person. S. 81A(3)(b).[1]

(k) Where a person has paid any penalty for not making payment of tax on the due date and the penalty is in excess of the amount due. S. 149(4).

(l) Where tas has been deducted at source from dividends.

(m) Refund of tax paid as a fine imposed by the Magistrate.

(a) Refund of tax paid in excess of the amount which a person was liable to pay.

A claim for refund of tax paid in excess must be made within three years of the end of the year of assessment as otherwise the claim will be prescribed. A person failing to make a claim within the prescribed period will lose the statutory right to the refund of the tax paid in excess.

The claim will apply to income tax, wealth tax or gifts tax paid in excess by deduction or otherwise but the claim for refund shall not operate:

(i) to extend or reduce the time limit for appeal; or,

(ii) to extend or reduce the time limit for a claim for repayment specified for such claims; or

(iii) to validate any objection or appeal which is otherwise invalid; or

(iv) to authorise the revision of any assessment or other matter which has become final and conclusive.

An executor, trustee or receiver can make a claim for refund in respect of the sum of tax paid in excess by any person who would have been entitled to claim such refund but has been prevented from doing so due to death, bankruptcy, incapacity, liquidation or other causes. The refund will be made to the benefit of such person or his estate. S. 149(2).

Limitation of refund.

Where a person is entitled to a set off of tax deducted in respect of any dividends, interest, rent, ground rent, or other royalty or other annual payment the amount of the refund is limited to the amount available as set off. S. 149(1)(ii).

(b) Refund of tax paid in excess due to any error in the return or an assessment.

Where a person has paid tax in excess of the amount which he was liable to pay for that year of assessment due to any error in the assessment or the return of income, wealth or gifts will be entitled to a refund of the tax paid in excess. The claim for refund must be made within three years of the end of the year of assessment in respect of which refund arises.

Error contemplated is an arithmetical error in the assessment or the return. Any error in the application or the construction of any provision of the law does not entitle any person to claim refund. Where a person does not agree with the application or the construction of the law as laid down by the Inland

1. 27 of 1982

Revenue Department, the question should be taken up on appeal to the proper appellate authorities provided in the Act. Normally where there has been an error by the taxpayer in treating exempt income as liable to tax or the taxpayer has failed to claim reliefs to which he is entitled to, the claim for refund can be made. S. 149(3).

(c) **Refund of tax paid by an Employer under PAYE Scheme which is in excess of the amount he should have paid.**

Where an employer has paid any sum for an year of assessment which is in excess of the amount which he should have paid he can apply for a refund within three years of the end of that year of assessment. Where the employer has failed to pay the amount due from him and an assessment has been made on him for the purpose of recovery, any sum paid on the assessment cannot be refunded. S. 149(5).

(d) **Refund of tax paid in excess on set off of capital loss at death.**

Where the revision of assessments are made by deducting unabsorbed capital loss at death of a person any refund arising shall be paid to the Executor or to such person or persons who are in the opinion of the Commissioner General entitled to the refund. It is lawful to revise the assessments for the three preceeding years and the years of assessment in which the death took place, although these assessments may be final and conclusive. There is no time limit prescribed for making the claim for refund. S. 29(6)(d)(ii).

(e) **Refund of tax paid in excess on set off of capital loss on liquidation of a company.**

Where revision of assessments are made by deducting unabsorbed capital loss of a company which is liquidated any tax found to have been paid in excess consequent to the revision of assessments shall be repaid.

(f) **Refund of tax paid in excess which arise on the revision of assessment which included interest receivable, which was subsequently found to be irrecoverable.**

Income arising from interest is the full amount of interest falling due whether paid or not. However, where it appears to an Assessor that where an assessment has been made which includes interest receivable and that such interest is irrecoverable, he shall revise the assessment although such assessment is final and conclusive. A refund, if any, arising can only be made by a claim made within three years of the end of a year of assessment which included such interest. S. 23(4).

(g) **Refund of tax paid in excess on the revision of assessment in which the Assessor refused deduction of annuity, ground rent, royalty or interest payable which was found to have been subsequently paid.**

An Assessor may refuse to allow any deduction from the statutory income any sum representing interest, ground rent, annuity or royalty payable. S. 29(2)(a)(iv). Where such sum has been subsequently paid and an application has been made within twelve months of such payment the assessment can be revised allowing such deduction even though the assessment has become final and conclusive. Any tax found to have been paid in excess as a result of such amended assessment is refundable notwithstanding that a claim for refund has not been made within three years of that year of assessment.

(h) **Refund of tax deducted in excess in respect of certain deposit accounts.** S. 32 B (2) (d).[1]

Interest received by any individual on certain deposits with a banking institution will be subject to deduction of tax at fifteen percent on the accumulated interest at the time of payment. However, the tax payable by him will be the maximum rate at which such individual is liable or fifteen percent whichever rate is the lower rate. Where the maximum rate at which such individual is liable to income tax is less than fifteen percent, then such individual will be entitled to a refund of an amount equal to the excess deducted.

(i) **Where tax is deducted or paid on Rs. 1,200 income from other sources of an employee whose income from employment does not exceed Rs. 30,000.** S. 9 (1) (l).[1]

The income from other sources profits or income not exceeding Rs. 1,200 of an individual who is in receipt of employment income which does not exceed Rs. 30,000 is not liable to income tax. Where income tax has been paid or deducted on such income the amount of tax deducted or paid shall be refunded. A claim for refund must be made within three years of the end of the year of assessment in which such profits have been exempt from income tax.

(j) **Refund of tax deducted on payments made to foreign entertainers or artistes.** S. 81 A (3) [1]

Payments made to foreign artistes and entertainers are subject to deduction of income tax at 33⅓%. Where such person is not liable to income tax or that the tax payable is less than the amount deducted will be entitled to a refund. The claim for refund must be made within three years of the end of the year of assessment to which such income relates.

(k) **Refund of penalty paid in excess.**

A person is liable to penalty where the tax due has not been paid on the prescribed date. Where a person has paid any penalty which is in excess of the amount which is payable by him, he is entitled to a refund of such excess. The claim for refund must be made within three years of the end of the year of assessment to which such penalty relates.

(l) **Refund of tax deducted on dividends.**

Any person other than a company is entitled to a set off of tax deducted on any dividends received from a resident company. Where such person is not liable to income tax or where the income tax payable is less than the tax deducted, such person is entitled to a refund. A claim for refund must be made within three years of the end of the year of assessment to which such dividend relates.

---

1. 27 of 1982.

(m) **Refund of tax paid as a fine imposed by the Magistrate.**

Where an order of a Magistrate imposing tax as a fine is set aside on the ground that the order is illegal, any payment made under such an order must be refunded. *Ranjit Wijemanne v. C.I.T.* 1 CTC 437.

2. **Interest payable on refunds.** S. 150.

Where any person is entitled to a refund of income tax, wealth tax or gifts tax paid by deduction or otherwise such person is entitled to interest on such refund remaining unpaid at one percent for each complete period of one month during which such refund remains unpaid.

The interest on refunds remaining unpaid will accrue as follows:

(a) Where the refund arises on the settlement of an appeal by agreement with the Assessor or on the determination of the appeal, the interest on any refund arising will accrue after six months of the date of such agreement or the date on which such determination was notified to such person.

(b) In all other cases the interest will accrue after six months of the notice of the claim by the taxpayer requesting repayment of tax.

3. **Time limit for claim of refund.**

A claim for repayment of income tax, wealth tax, or gifts tax must be made within three years of the end of the year of assessment in respect of which the repayment relates. A claim which is not made within the time limit is prescribed.

However, where the Commissioner General of Inland Revenue is satisfied that a person who has paid income tax, wealth tax or gifts tax by deduction could not have made a claim within the prescribed three years, such person will be entitled to a refund, if such a claim is made within one year of assessment in which such deduction has been made. S. 149(1)(iii).

Chapter 32

PENALTIES AND OFFENCES

The committing of the following offences will attract punishment under the provisions of the Inland Revenue Act:

(1) Furnishing of incorrect return. S. 124.

(2) Failure to comply with certain requirements under the Act and failure to comply with any notice issued by the officers appointed under the Act. S. 151(1).

(3) Fraud. S. 153.

1. Furnishing of incorrect returns:

Where an assessment has been made on any person, and that the amount of the income, wealth or gifts exceeds the amount shown in the return made by that person and that such assessment is final and conclusive the Commissioner General may require such person to prove to his satisfaction that there is no fraud or wilful neglect involved in the disclosure of the income, wealth or gifts. Where such person fails to prove that there is no fraud or wilful neglect, he may take any of the following three steps in punishing the offender:

(1) Impose a penalty;

(2) Prosecute for making incorrect returns;

(3) Prosecute for fraud.

2. Imposition of Penalty by the Commissioner General S. 124.

Where any person fails to prove that there is no fraud or wilful neglect in making a return he may impose a penalty of a sum not exceeding:

(a) Rs. 2,000; and

(b) a sum equal to twice the tax evaded.

Where the Commissioner General has imposed a penalty, on any person such person shall not be liable to a prosecution for making an incorrect return or fraud. S. 124(4).

Any person in respect of whom a penalty has been imposed may appeal against such order within twenty one days to the Board of Review stating precisely their grounds of objection to such an order. S. 124(3). The Board of Review shall hear such appeal and may confirm, reduce, increase or annul the penalty imposed. Where the Board of Review decides to increase the penalty such penalty shall not be more than the amount which the Commissioner General could have imposed for the offence.

3. **Prosecution for furnishing incorrect returns.** S. 151(4).

Every person who;

(a) makes or furnishes an incorrect return by omitting or understating any income, wealth or gifts either on his own behalf or on behalf of another person; or

(b) makes an incorrect statement in connection with a claim for a deduction or allowance; or

(c) gives an incorrect information in relation to any matter or thing affecting his own liability to tax or the liability of any other person or a partnership.

shall be guilty of an offence liable to prosecution before a Magistrate for the offence. A person found guilty of such offence shall be liable, on conviction after summary trial, to a fine consisting of a:

(a) sum equal to the amount of the tax undercharged; and

(b) sum not exceeding Rs. 5,000; or

(c) to imprisonment for a term not exceeding six months; or

(d) to both fine and imprisonment.

An employer who makes an incorrect declaration omitting or understating the amount of remuneration of any employee in his employ or omits or understates the amount of income tax deducted is liable on conviction on a summary proceeding before a Magistrate to a:

(a) fine not exceeding Rs. 5,000; or

(b) imprisonment, not exceeding six months; or

(c) both fine and imprisonment.

An employee giving incorrect statement in respect of a declaration required under PAYE regulations will be liable on summary conviction before a Magistrate to:

(a) a fine not exceeding Rs. 5,000; or

(b) to imprisonment for a period not exeeding six months; or

(c) to both fine and imprisonment.

4. **Prosecution for failure to comply with certain provisions of the Act and notice issued thereunder.** S. 151(1).

Failure to comply with the requirements of the Act and notice might entail prosecution before a Magistrate. The penalties are imposed on failure to comply with the law.

5. **Fraud.** S. 153(1).

Any person who commits any of the following and thereby evades or attempts to evade or assists any other person to evade or attempt to evade income tax wealth tax or gifts tax shall be guilty of an offence.

The offences in respect of which penalties are imposed are where any person:

(a) omits from a return made any income, wealth or gifts which should have been included; or

(b) makes any false statement or entry in any return made; or

(c) makes a false statement or entry in connection with a claim for a deduction or allowance; or

(d) signs any statement or return furnished without reasonable ground for beliving the same to be true; or

(e) gives false answers whether verbally or in writing to any question or request for information asked or made; or

(f) prepares or maintains or authorises the preparation or maintenance of any false books of account or other records or falsifies or authorises the falsification of any books of accounts or records; or

(g) makes use of any fraud. art, or contrivance whatsoever, or authorises the use of any such fraud, art, or contrivance.

6. **Evade.**

The use of the word evade has two meanings: one is legal avoidance of tax and the other is illegal avoidance of tax in the above manner. The meaning of the word evade has been expounded in the case of *Simms & Others.* (1900 AC 823):

"Everybody agrees that the word is capable of being used in two senses: one which suggests underhand dealing, and another which means nothing more than the intentional avoidance of something disagreeable".

7. **Prosecution must be sanctioned by the Commissioner General**

Any proceeding under these provisions can only be taken at the instance of or with the sanction of the Commissioner General. S. 155. It must also be noted that the institution of any proceedings for fraud and imposition of penalty or a term of imprisonment does not relieve any person from the liability of the payment of tax for which he is chargeable. S. 154. The penalties for evasion or fraud are due in addition to the liability to tax in respect of which such person is chargeable.

The Revenue will generally prosecute any person in the case of evasion of serious nature. In the case of evasion of tax the Revenue is vested with three alternatives open to it. The Commissioner General has the absolute discretion to take any of the steps to bring to book the offender.

These proceedings are invoked after the settlement of the liability and after the assessments have become final and conclusive. When settling the additional liability it is advisable to make the full disclosure regarding the evaded income and appeal to the Commissioner General for an assurance against any criminal proceedings. In the case of evasion by fraud of a serious nature the Revenue is likely to insist on criminal proceedings being taken so as to bring to public notice the seriousness of the evasion as a preventive measure. The Commissioner General will usually decide on the merits of each case for appropriate action.

8. **Evidence of evasion.**

In proceedings against any person for evasion the onus of proving that a person has evaded tax lies on the taxing authorities. The burden lies with the State to prove that a person had evaded tax by these means and must prove beyond reasonable doubt to make a person liable under these penal provisions. In these proceedings the department can produce any statement made or document produced in relation to any matter arising under the Inland Revenue Act by any person who is chargeable with tax or his authorised representative to the Commissioner General, Deputy Commissioner or to the Assessor Notwithstanding anything in any other law such statement or document shall be admissable evidence against any proceedings for the purpose of obtaining conviction for evasion of tax. S. 156

An Assessor is not prevented by the secrecy provisions from disclosing statements and facts in his possession to the State Counsel or the Courts under this proceedings, as regards taxpayers matters, coming to the notice of the Assessor, Such intimation will be in the performance of his duties which is within the exception provided. S. 158(1). *Mitrasena v. Jayanetti* 3 CTC 328. Any statement made in consequence to a threat, inducement or promise coming from a person in authority should in the opinion of the Court give the accused grounds which would appear to him reasonable for supposing that by making an admission he would gain advantage or avoid evil of a temporal nature in reference to the proceedings against him. For a statement to be inadmissible under section 24 of the Evidence Ordinance, the effects of the inducement, threat or promise should not have been dissipated by the time the confessional statement was made. *Mitrasena v. Jayanetti.*

9. **Appeal settlement is no bar to any proceedings.**

A settlement of an appeal did not amount to a compouding of the offence committed and was no bar to the institution of criminal proceedings. The only ground on which no criminal proceedings will be instituted will be the absence of any fraud or wilful neglect in the disclosure made in the return of income. *Mitrasena v. Jayanetti.*

10. **Intention to Evade.**

In order that a person be brought under the penal provisions, the law requires that a person has by some act contrived to evade tax. Where there is sufficient evidence before the Courts to show that the non-disclosure of the item of income in question was clearly the result of dishonesty on the part of the Assessee, the State has discharged its onus and the charges will remain proved: *Mitrasena v. Jayanetti.*

11. **Omission from the return.**

To attract punishment, the omission must be done deliberately with evil intention of defeating unlawfully the object of the statute by knowingly presenting a false picture of the income of the person making the return by omitting therefrom material which the taxpayer knows should properly be there. A person cannot be punished for omitting in his return certain sums which he claimed as secret commissions paid by him; the fact that he submitted to pay tax on these sums did not by itself bring him within the ambit of the penal provisions. *Chellappa v. C.I.T.* 1 CTC 382.

A taxpayer is entitled to construe the taxing statute and make his return in accordance with his understanding of it. An omission based on a mistaken view of the law or facts does not attract punishment. The taxing authorities are not bound by the taxpayers views of the law or by its methods of accounting. They are free to reject his interpretation and assess him on what they think is the correct basis.

12. **False statement or false entry.**

The mere fact that the statement or entry is false in fact does not bring the person making it within the ambit of the provisions. In the first place the statement or entry must in fact be false as otherwise there is no offence. The false statement or entry must be deliberately made with the knowledge that it is false and with the evil intention of thereby misleading the taxing officer. The object of the false statement or entry should be to defeat the purpose of the statute, to deny to the revenue its legitimate dues. A statement or entry which is in fact false if made inadvertently or honestly or in the belief that it is true does not attract punishment if the taxpayer stood to gain by the statement or entry if it passed undetected. *Chellappa v. C.I.T.* 1 CTC 382.

13. **System of book-keeping.**

The system of book-keeping adopted by a taxpayer does not bind the taxing authorities and a taxpayer cannot escape tax by adopting a particular method of book-keeping. But he cannot be punished for taking a view of his income which does not accord with that taken by the taxing authorities. Basnayake J. in *Chellappa v. C.I.T.*

14. **Psychological Factor.**

"In applying the highly penal provisions of the Income Tax Ordinance the Crown should not lose sight of the fact that our taxing statute, though still not so complex as the Law of England, is complex enough to baffle the average taxpayer who finds himself unable to complete the return unaided. Many of them have to seek the aid of their legal advisers or income tax advisers or their accountants, by whom they are guided. A taxpayer who seeks a professional advisor's aid as a matter of course adopts the view his advisor takes of the law and his earnings. If the taxpayer is himself not an accountant he is also largely in the hands of a book-keeper who decides the proper head under which entries relating to his income and expenditure should be made. A psychological factor which cannot be ignored in such a situation is that the taxpayer rarely imposes his will on his advisors". Basnayake J. in *Chellappa v. C.I.T.* The Court will thus require evidence beyond reasonable doubt that the Assessee deliberately committed the offence.

15. **Contents of the return.**

A return, statement or form purporting to be furnished under this Act by or on behalf of any person shall for all purposes be deemed to have been furnished by that person or by his authority, as the case may be, unless the contrary is proved, and any person signing any such return, statement or form shall be deemed to be congnizant of all the matters therein. S. 92(8). Although it is not open to the accused to say that although he signed the return he was not congnizant of everything that appeared in the return, in the statement of particulars, and in the form, the procecution must show from all the other relevant facts and matters that the only reasonable intention that a prudent man ought to draw is that the accused intended to evade the tax. *Piyasena v. Vaz* 1 CTC 298. Thus in order to arrive at this conclusion, the whole circumstances attaching to the evasion will be looked into in deciding the seriousness of the offence to come to a definite conclusion beyond all reasonable doubt that the person intended to evade tax.

16. **Fraud.**

Fraud implies intention to deceive *(Derry v. Peek)* and in its legal connotation is wider than it is in popular usage. It is only proved where it is shown that a false representation has been made:

(i) knowingly; or
(ii) without belief in its truth; or
(iii) recklessly or carelessly whether it be true or false.

In *Derry v. Peek,* Lord Herschell observed that a man may be blameworthy when he makes a representation on which another is to act, but he is not fraudulent if he "forms" his belief carelessly or if he is unreasonably credulous.

17. **Amount of the Penalty.** S. 153.

A person on conviction for any offence is liable to a fine consisting of:

(a) a sum equal to the amount of the tax evaded; and
(b) a sum not exceeding ten thousand rupees; or
(c) to imprisonment to a term not exceeding six months or to both fine and imprisonment.

The Magistrate has discretion as regards the amounts in respect of the fine of ten thousand rupees only and not on the fine of the sum equal to the tax evaded. See *Mitrasena v. Jayanetti.*

Chapter 33

TAX REBATES AND INCENTIVES

Tax Rebates and incentives available under the Inland Revenue Law provides an option to taxpayers to minimise their tax liabilities. Taxpayers must therefore, utilise all options open to them to minimise their tax liabilities as is legitimately possible. Profit maximisation in tax planning depends on the maximum utilisation of all options available to keep the hands of the revenue out of the cash flow by minimising the tax cost of the business.

Evasion

An outright evasion, the main feature being cash hoard, is a foolish management of the cash flow since such hoarded cash would have lost its interest growth factor and has also failed to play its part in the growth of the business. Above all such hoard would have been eroded in value year by year by inflation.

Avoidance

Tax avoidance is an attempt to arrange a person's affairs in such a way as to pay minimum amount of tax legitimately.

"No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved." Lord Upjohn in *C.I.R. v Brebner* 43 TC 750.

The Courts do not frown upon legitimate tax avoidance schemes even if the motive for such transaction may be to avoid tax unless the law prohibits such transaction. Where a document or transaction is genuine, the courts cannot go behind to some supposed underlying substance.

In the case of artificial tax avoidance schemes, the Courts will examine the overall effect of those transactions to ascertain the legal nature of such transactions. The recent decision of the House of Lords in *Ramsay V C.I.R.* and the principles laid down by courts in that case would seriously affect the effectiveness of artificial tax avoidance schemes.

"While the techniques of tax avoidance progress and are technically improved, the courts are not obliged to stand still. Such immobility must either result in a loss of tax, to the prejudice of other texpayers, or to Parliamentary congestion or (most likely) to both. To force the courts to adopt in relation to closely integrated situations, a step by step, dissecting, which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process. In each case the facts must be established, and legal analysis made: legislation cannot be regarded or even be desirable to enable the courts to arrive at a conclusion which corresponds with parties own intentions." Lord Wilberforce: *Ramsay v. C.I.R.* 1980 HL.

Incidence of Tax

The incidence of income tax on individuals and companies is shown in the following tables which shows the income, the income tax payable, the effective rate of tax and the balance income after tax. In the case of companies, where a full distribution of the profits to shareholders is made the incidence of income tax appear severe.

The tables indicate the tax cost to the individual or a company at varying taxable income levels. The effect of Gifts Tax and Estate Duty should also be taken into account in considering the overall impact of taxation on individuals, who ultimately, are the owners of the resources.

Table I

Resident Individuals:

Taxable Income	*Income Tax*	*Effective Rate of Tax*	*Income after Tax*
Rs. 100,000	41,560	41.5	58,440
200,000	96,560	48.2	103,440
300,000	151,560	50.5	148,440
400,000	206,560	51.6	193,440
500,000	261,560	52.3	238,440

Table II

Small Companies:

Rs. 50,000	10,000	20.0	40,000
100,000	25,000	25.0	75,000
200,000	60,000	30.0	140,000
300,000	105,000	35.0	195,000
400,000	155,000	38.7	245,000
500,000	205,000	41.0	295,000

Where the entirety of the balance income after tax of a Small Company is distributed to shareholders who are assumed to be liable at the maximum marginal rate of 55 percent, then

Income Tax on the Company on taxable income of Rs. 500,000.			Rs. 205,000
Income Tax on shareholders	295,000	55%	162,250
Total Tax liabilities.			Rs. 367,250
Effective rate of tax on profits earned by the Company.			73.45%

Table III

Resident Company:

Taxable Income	...	...	...	Rs. 500,000
Income Tax 50%	...	...	...	250,000
Income after Tax.	...	...	...	Rs. 250,000

Where the entirety of the balance of the profits after tax is declared as dividends to shareholders who are assumed to be liable at the marginal rate of tax of 55% then.

Income Tax Rs. 500,000	50%	... ...	Rs. 250,000
Income Tax on shareholders 250,000	55%	...	140,250
			Rs. 390,250
Effective rate of Tax on profits earned by the Company....			75.05%

Table IV

Non-Resident Company:

Profits Rs. 500,000	55%	Rs. 275,000
Remittance tax on the assumption that the balance of the profits are remitted and exceed one third of taxable income.		
Taxable Income Rs. 500,000	11.1%	55,500
		Rs. 330,500
Effective Rate of Tax on profits earned by a non-resident Company		66.1%

Table V

Gifts Tax-Individuals on the value of property gifted:

Gifts	*Gifts Tax*	*Effective rate of tax*	*Balance after gifts tax*
Rs.	Rs.		Rs.
550,000	75,000	13.6	475,000
750,000	135,000	18.0	615,000
950,000	205,000	21.5	745,000
1,150,000	285,000	24.7	865,000
2,050,000	750,000	36.5	1,300,000
3,050,000	1,400,000	45.9	1,650,000
5,050,000	2,800,000	55.8	2,250,000

Table VI

Estate Duty on the value of property left at death:

Value of Estate	*Estate Duty*	*Effective rate of Duty*	*Balance of Estate after payment of duty*
Rs.	Rs.		Rs.
500,000	50,000	10.0	450,000
800,000	135,000	16.8	665,000
1,000,000	205,000	20.5	795,000
1,900,000	640,000	33.6	1,260,000
2,900,000	1,265,000	43.6	1,635,000
3,900,000	1,965,000	50.3	1,935,000
5,000,000	2,735,000	54.7	2,265,000

Investment Decisions:

The tax factor including the timing of the tax payments, must be considered when investment decisions are taken as tax forms an important component of the cash flow. It is also important to consider the method of financing; whether it is to be out of Capital account or revenue account. A decision to purchase or lease a capital asset will have its impact on the cash flow. The capital allowances available in respect of expenditure on plant, machinery or fixtures must also be taken into account.

In determining whether leasing or purchasing is more advantages in pure financial terms, the timing of allowances and availability of taxable profits to utilise the allowances are crucial factors. In leasing or purchasing there are no tax advantages, one over the other, without considering the allocation of tax deductions, as in both cases the total cost incurred are allowable as deduction in computing profits.

The loan capital has an advantage over equity capital and the relative advantage is emphasized by the deductibility of interest. Where there are tax incentives by way of the tax holiday the period of the tax holiday can be utilised for the payment of debt out of gross income before taxation. Where it is possible to carry forward capital allowances beyond the tax free period, there is a further period during which the ventures income, gross of tax, can be utilised for repayment of loans.

Tax Incentives:

Inland Revenue Law provides a combination of tax incentives by way of exemption from income tax, tax holiday for specified periods for certain undertakings and tax rebates for investment made in an year of assessment. Tax advantages also accrue on account of deductibility of capital expenditure in certain ventures and on account of enhanced depreciation allowance. Incentives are also provided in respect of certain undertakings carried on by limited liability companies. Apart from incentives available to certain undertakings carried on by the limited liability companies, the carrying on of business as a limited liability company provide certain tax advantages.

A reduction in assessable income may be achieved by any person by an investment in qualifying payment up to one third of that person's assessable income; certain specified qualifying payment qualify for deduction of the full cost of such investment without any limitation with facility to carry forward the balance in excess of assessable income to subsequent years of assessment. Where the investment is in shares in approved companies, which are entitled to tax holiday, the dividend income will also be tax free during the specified period.

In the case of ventures in agriculture, sericulture, animal husbandry and inland fishing projects, the law provides for deduction of certain capital expenditure, which would result in losses in the first few years operation till the venture starts to yield income. Losses of such undertakings incurred by any person, other than lossess of undertaking which are entitled to exemption from income tax, can be deducted from other sources of profits or income of that person in that year of assessment. Where there are profits it may be advantageous to diversify into such undertakings taking into consideration the tax savings that accrue.

Final Date for approval of Tax Holiday Undertakings:

The Inland Revenue Amendment Act No. 27 of 1982 provides for a cut off period for approval by the Minister for exemption from income tax. In terms of the amendment exemption from income tax will apply only to undertakings which have been approved by the Minister of Finance by order published in the Gazette prior to March 31, 1983. The following undertakings which will not qualify for tax holiday for specified period unless such undertakings are approved by the Minister by order published in the Gazette prior to March 31, 1983 are

1. Undertakings of operating hotels for tourists. S. 16 (a).
2. Undertakings of operating hotels for tourists in a quoted public company with equity capital of over Rs. 100 Million. S. 16 A.[1]
3. Undertakings of providing hotels for tourists which construct additional bedrooms for use. S. 16 B[1]
4. Companies carrying undertakings of
   (a) off-shore and deep sea fishing.
   (b) agriculture.
   (c) Animal husbandry.
   (d) Sericulture. S. 17.
5. Small and medium scale undertakings for production or manufacture of commodities. S. 18.
6. Undertakings for the milling of Paddy. S. 19.
7. Companies carrying on an undertaking for manufacture and export of commodities or for providing services for payment in foreign exchange. S. 20.
8. A Quoted Public Company performing contracts with the Mahaveli Authority. S. 22 A.[1]
9. A Quoted Public Company engaged, in Property Development. S. 22 B.
10. Quoted Public Companies carrying on Pionnering and Import substitution Industries. S. 22 C.[1]
11. Quoted Public Companies undertaking large scale agriculture and processing of the produce. S. 22 D.[3]

Cancellation of Approval granted for Tax Holiday.

Where an undertaking has been approved by order published in the Gazette for tax holiday and the Commissioner General of Inland Revenue is satisfied that no steps have been taken to commence the undertaking approved by such an order within one year of such approval he may recommend to the Minister of Finance that such approval be cancelled. S. 22 E.[2] The Minister of Finance, having regard to the interests of the economy, may cancel such approval by order published in the Gazette.

Approvals granted by the Minister of Finance in respect of the following projects may be withdrawn if no steps have been taken to commence such undertakings within one year of the approval:

1. 24 of 1980. 2 27 of 1982 3 40 of 1981.

1. Tourist Hotel Projects. S. 16. 16A and 16B.
2. Export undertakings. S. 20.
3. Undertakings handling Mahaveli Contracts. S. 22 A.
4. Property Development Projects. S. 22 B.
5. Import Substitution and Pioneering Industries. S. 22 C.
6. Large Scale Non-traditional Agriculture and Processing of Agricultural produce. S. 22 D.

Tax Incentives under Inland Revenue Act.

Tax incentives provided under the Inland Revenue Act are discussed under the following headings:

1. Qualifying Payments.
2. Business carried on by Limited Liability Companies.
3. Tax Incentives for Housing.
4. Tax Incentives for Tourist Industry.
5. Tax Incentives for Milling of Paddy.
6. Tax Incentives for small and Medium Scale manufacturing undertakings.
7. Tax Incentives to Non-Resident Contractors.
8. Tax Incentives for non-traditional Agriculture, Sericulture, and animal Husbandry.
9. Tax Incentives for Large Scale Non-Traditional Agriculture.
10. Tax Incentives for agricultural undertakings.
11. Tax Incentives for Fishing.
12. Tax Incentives for Exports and the provision of services for payment in foreign exchange.
13. Tax Incentives for pioneering and Import substitution industries.
14. Tax Incentives for Property Development.
15. Tax Incentives for Mahaveli Contractors.
16. Tax Incentives to the Gem Trade.
17. Tax Incentives for investment in Greater Colombo Economic Commission.
18. Tax Incentives to foreign currency banking unit.
19. Tax Incentives for operation of yachts and pleasure crafts by Non-citizen
20. Tax Incentives for Entrepot Trade.
21. Tax Incentives to Resident Individuals, Partnerships and Resident Companies to bring into Sri Lanka profits and income earned abroad.
22. Tax Incentives to off-shore shipping companies.
23. Exemption in respect of certain Income from Interest.
24. Relief from Double Taxation.
25. Tax Exemption to Resident Guests.
26. Gifts Tax and Estate Duty.

1. Qualifying Payment.

A person is entitled to deduct from his assessable income for any year of assessment in respect of every qualifying payment made by him in that year of assessment an allowance equal to the amount of such qualifying payment, subject to certain conditions. S. 31. A qualifying payment is the amount of any payment, expenditure or investment made in an year of assessment, which qualify for deduction from that person's assessable income in an year of assessment. The effect of the deduction in respect of the qualifying payment from a person's assessable income is to reduce the taxable income and thereby secure a reduction of the tax payable by that person. The amount of the reduction in tax payable depends on the rate of income tax at which such person is liable to income tax and the amount of the reduction of the taxable income.

The rates of income tax at which a person is liable is prescribed in the Inland Revenue Act. A progressive income tax rate structure applies to individuals, both resident and non-resident, a small company and a Hindu undivided family, while a fixed rate per centum applies to all other persons. The reduction in income tax payable that an individual, a small company or a Hindu Undivided Family can achieve will vary depending on the rates of taxation applicable to the level of income and the amount of the reduction in taxable income on account of the qualifying payments. In the case of all other persons other than an individual, small company or a Hindu Undivided Family the reduction in tax that can be achieved is measured by applying the rate of income tax on the amount of the qualifying payment that such person is entitled to deduct from his assessable income.

Extent of deduction on account of qualifying payment.

The deduction from the assessable income in respect of qualifying payment made by any person is restricted to one third of that person's assessable income for that year of assessment, except in respect of the following qualifying payment, which qualify for deduction without any limit and where the full amount of investment cannot be deducted in full, the excess can be carried forward for set off in subsequent years of assessment: S. 31 (6).

(a) a donation made to the Government, to a local authority, to a fund established or deemed to be established under the Universities Act No. 16 of 1978;[1]

(b) Any approved expenditure. S. 31 (2) (c);

(c) any sum invested by any person in purchase of ordinary shares of a company engaged in Tourist Hotel Project or engaged in property Development or engaged on large scale agricultural projects cultivating non-traditional agricultural crops[1] the 'capital' of which exceeds five hundred million ruppes. S. 31 (2)(m).[2]

Where the qualifying payment made by an individual consits of an amount spent by him out of his own cash resoures in the purchase or construction of a house or the purchase of a site for the construction of a house, such individual may apportion the amount spent by him between five years of assessment. S.·31 (3). The amount apportioned, together with the qualifying payments shall not exceed one third of the assessable income for an year of assessment. S. 31 (5).

1. 27 of 1982. 2. 27 of 1982.

Meaning of Qualifying Payment. S. 31(2).

Qualifying payments that can be deducted from the assessable income are grouped under:

(A) Qualifying payments which all persons are entitled to deduct; and

(B) Qualifying payments which an individual only is entitled to deduct.

(A) **Qualifying Payments which all persons can deduct.**

(I) a donation made in money to

(a) an approved charity. S. 31 (2) (a). The meaning of approved charity is described below.

(b) the Ceylon Institute of Scientific and Industrial Research. S. 31 (2) (k) (1).[1]

(c) the Sri Lanka Foundation. S. 31 (2) (k) (ii).[1]

(d) the Tower Hall Theatre Foundation. S. 31 (2) (k) (iii)[1]

(e) the Sri Lanka Inventors Commission. S. (31) (2) (k) (iv)

(f) the S. W. R. D. Bandaranaike National Memorial Foundation. S. 31 (2) (k) (v).[2]

(g) the Institute of Fundamental studies. S. 31 (2) (k) (vi).

(h) the International Winged Bean (Dambala) Institute. S. 31 (2) (k) (vii).[3]

(II) a donation in money or otherwise to

(a) the Government

(b) a local authority

(c) a fund established by the Government

(d) a fund established by a local authority and approved by the Minister.

(e) Higher Educational Institution.[3]

(III) Expenditure incurred on any project included in the development plan of the Government provided that,

(a) such expenditure was incurred with the prior written approval of the Minister; and

(b) conforms to such terms and conditions specified by the Minister for the grant of such approval having regard to the development priorities of the Government. S. 31 (2) (b).

(IV) any sum invested in the purchase of ordinary shares, other than existing shares in an approved undertaking carried on by a company. S. 31 (2) (d). The meaning of approved undertaking is discussed below.

(V) any sum spent in the purchase of ordinary shares, other than existing shares in a quoted public company the capital of which exceeds five hundred million rupees engaged in

(a) Tourist Hotel projects. S. 16 A[1]

(b) Property Development projects. S. 22 B.[1]

(c) Large scale non-traditional agricultural projects and processing of the produce of such projects. S. 22 D[2]

---

1 24 of 1980 2. 40 of 1981 3. 27 of 1982

In computing the capital of five hundred million rupees the aggregate of the following are taken into consideration.

(a) the cost of building purchased or constructed and of any land, plant, machinery and fixtures purchased for use in that undertaking; and

(b) the value of other assets of that undertaking ;

(c) profits retained in the business: S. 18.

(VI) any amount spent by any person in constructing a house or flat or cost of purchase of any unit of residential accomocation constructed with the approval of the Urban Development Authority and comprised in a registered condominium property; if

(a) such house, flat or unit is for the occupation as a dwelling house by any member of the staff employed by such person;

(b) the floor area of the house, flat or unit does not exceed 2000 square feet,[2] and

(c) no depreciation allowance is deductible. S. 31 (2) (1).[1]

(B) **Qualifying Payments which an Individual only is entitled to deduct.**

(I) any amount paid by an individual to the Government, to any Banking Institution or to any local authority or any other institution approved by the Minister for Housing:

(a) in the repayment of capital of any loan granted on or after April 01, 1973, for the construction of a house or for the purchase of either the first house or the first site for the construction of a house, while such individual is the owner of that house or site;

(b) amount paid as monthly payment in respect of any house let on or after April 01, 1973 on rent purchase terms: S. 31 (2) (c). The word purchase is deemed to include a lease of a unit of residential accomodation constructed with the approval of the Urban Development Authority and comprised in a registered condominium property within the Apartment Ownership Law if:

(i) such lease is for a period exceeding 50 years; and

(ii) consideration was paid in full at time the agreement of lease was entered into: S. 31 (2)[2]

(II) any amount certified by the Commissioner of National Housing as having been spent on the construction of a house out of an individual's own financial resources. To qualify for deduction the cost of construction should not have been financed out of loan from,

(a) the Government.

(b) any Banking institution.

(c) any local authority.

(d) any other institution approved by the Minister of Housing.

The Commissioner General has indicated that the Department of Inland Revenue will not in future require a certificate from the Commissioner of

---

1 24 of 1980 2 27 of 1982

National Housing, and that the Law will be suitably amended. The Department of Inland Revenue will consider relief if the following documents are forwarded with the claim

(a) certificate of conformity,
(b) copy of the approved plan of the house,
(c) statement of details of cost of construction or certificated bill of quantities.

(III) Any amount spent for the purchase on or after April 01, 1978 of either the

(a) first house; or
(b) the first site for the construction of a house.

To qualify for deduction the cost of purchase should not have been financed out of a loan from

(a) the Government,
(b) any Banking institution,
(c) any local authority,
(d) any other institution approved by the Minister for Housing. S. 31 (2) (g).

The term 'purchase' of house include a lease of any unit of residential accomodation constructed with the approval of the Urban Development Authority and comprised in a registered condominium property, if

(a) the lease is for a period of over fifty years; and
(b) consideration for such lease was paid in full at the time of the agreement: S. 31 (2).[1]

(IV) any premia paid on a life insurance policy or a policy of medical insurance or an amount paid for the purchase of an annuity, other than premia paid outside Sri Lanka:—

(a) in respect of any policy issued outside Sri Lanka after July 04, 1957; or
(b) for the purchase of an annuity outside Sri Lanka after July 04, 1957. S. 31 (2) (h).

(V) any contribution made to an approved pension or provident fund or to a regulated provident fund if the emoluments from which contributions are made are liable to income tax. S. 31 (2) (i).

(VI) any expenditure incurred by a professionally qualified person in

(a) the payment of subscription to any professional association of which he is a member or in the purchase of professional books, journals and reports; and
(b) on expenditure on travel abroad to participate in any seminar or conference relating to the profession carried on by him if such purpose is approved by the Minister as being of benefit or general advantage to the profession. S. 31 (2) (j).

---

1 27 of 1982

Restrictions on the deduction of Qualifying payments:

Following restrictions will apply to deductions a person can claim;

(a) **Payments made out of deposit made under the Tax Anmesty Act No. 5 of 1978:**

A person who made any qualified payment out of the withdrawal of any money deposited with the National Savings Bank in terms of Anmesty Act is not entitled to any deduction from the assessable income in respect of such qualified payments; S. 31 (2).

(b) **The aggregate of certain qualified payments not to exceed one third of the assessable income. S. 31 (5).**

The aggregate of the following qualified payments shall not exceed one third of the assessable income of that person for that year of assessment. These deductions are:–

(i) donation to approved charities;

(ii) Investment in shares in approved undertakings;

(iii) Repayment capital of any loan to purchase a house or building site;

(vi) Monthly payments under rent purchase scheme;

(v) Amount spent on the construction of a house financed out of an individual's own financial resources;

(vi) Amount spent on the purchase of the first house or first site for the construction of a house financed out of an individuals own resources;

(vii) Premia of life insurance policy, medical insurance or the purchase of an annuity;

(viii) Contributions to an approved Provident Fund or a regulated provident fund;

(xi) Expenditure of a professionally qualified Individual;

(x) Cost of construction of a house or flat or cost of purchase of a condominium property for occuption by an employee. S. 31 (2) (1).

Facility to deduct the total qualifying payment and to carry forward any balance.

The following qualifying payments can be deducted from the assessable income without any limitation and the excess, if any, can be carried forward for set off in the subsequent years of assessments till the total qualifying payment made is fully set off: S. 31 (6)

(a) Donation made in money or otherwise to the

(i) Government;

(ii) Local authority;

(iii) Fund established by the Government;

(iv) Fund established by the local authority and approved by the Minister;

(v) Higher Educational Institution.

(b) Approved Expenditure.

(c) any sum invested in the purchase of ordinary shares of a company engaged in Tourist Hotel Project or property Development Project or a project of large scale non-traditional agriculture and processing of such produce the capital of which is not less than five hundred million rupees.

Apportionment of certain Qualifying Payments. S. 31(5)

Where an individual made a qualifying payment out of his own cash resources in

(a) the purchase of a house;
(b) construction of a house;
(c) purchase of a site for the construction of a house.

may apportion the amount expended between five years of assessments provided that:–

(a) the total amount spent shall not be apportioned for more than five years of assessments; and
(b) that such individual continues to be the owner in that year of assessment.

Any amount paid by an individual for a lease will be regarded as cost of purchase, if

(a) the lease is for a period exceeding 50 years;
(b) the entire consideration was paid at the time of entering the lease;
(c) that the lease must be in respect of unit of residential accomodation constructed with the approval of the Urban Development Authority and comprised in a registered condominium property.[1]

Qualifying Payment of a child. S. 31(4).

Where the total statutory income of a child is aggregated with and is deemed to be a part of the total statutory income of his parent, any qualifying payment made by that child in that year of assessment shall be deemed to be a qualifying payment made by such parent. Any limitation on account of the qualifying payment is determined in relation to the total statutory income of the child and the parent.

Donation made to an Approved Charity. S. 31(9)(a).

In order to qualify for deduction as a qualifying payment, such donation must be made to an approved charity.

An approved charity means any public charitable trust or institution as is declared by the Minister by notice published in the Gazette as an approved charity. S. 31 (9) (a). The Minister of Finance approves charities which are engaged in the following activities:–

(a) relief of poverty;
(b) medical relief;
(c) advancement of education;
(d) construction or renovation of a place of public worship as is recommended by the Minister for Cultural Affairs.

Religious institutions do not qualify for approval as approved charities. In the case of institutions which are engaged in several activities. which

1. 27 of 1982

are outside the scope of the objects stated above, may be granted apporval in respect of an activity which is within the concept of a charitable purpose, for example, an educational fund, medical relief etc., provided the institution maintain separate accounts and the funds are utilised solely for the purpose for which approval is granted.

Approved Undertakings: S. 31(a)(b).

Any person is entitled to deduct from his assessable income the amount invested in the purchase of ordinary shares in a company which is an approved undertaking. An approved undertaking means, a company which is approved by the Minister of Finance as being essential for the economic progress of Sri Lanka by notice, published in the Gazette. Approved Undertaking status is given to a company which is engaged solely in:–

(i) (a) carrying on an undertaking which is capable of exporting goods or commodities or of providing services for payment in foreign currency;

(b) construction and sale of houses;

(c) the development and the sale of land for building purposes under any scheme approved by the Minister of Housing;

(d) the construction and sale of houses and in the development and sale of land for building purposes under any scheme approved by the Minister of Housing;

(e) carrying on an undertaking which is considered by the Minister of Finance as essential for the economic progress of Sri Lanka.

(ii) A company with which an agreement has been entered into by the Greater Colombo Economic Commission. S. 31(a)(b).

The Ministry of Finance has laid down the following guidelines for the grant of "Approved Undertaking" status under section 31 (9)(b) of the Inland Revenue Act.

(1) The undertaking should be carried on by a company;

(2) The undertaking must be considered as essential for the economic progress of Sri Lanka;

(3) The undertaking should be recommended by the appropriate Ministry or Authority;

(4) The company need not be a Quoted Public Company to qualify for approved undertaking status;

(5) The other guidelines which are applied to determine whether an undertaking is eligible for a tax holiday will be applicable for the grant of approved undertaking status.

(6) The "approved undertaking" status will be limited to a period of five years from the date of the first issue of shares;

(7) The undertaking should be engaged in one or more of the following activities which are normally eligible for tax holiday:-

(a) Operating a hotel for tourists or expansion of existing hotels by providing additional rooms. S. 16(a), S. 16A, S. 16D.

(b) Off-shore and deep-sea fishing; S. 17.

(c) Agriculture, other than tea, rubber, coconut or paddy. S. 17.

(d) Animal Husbandry. S. 17.

(e) Sericulture. S. 17.

(f) Processing of the products of any activity referred to in paragraphs (b), (c), (d) and (e) so long as the processing is carried on in combination with such activity. S. 17.

(g) Building fishing boats or manufacture of fishing gear or the manufacture or assembly of marine engines. S. 17.

(h) Manufacture of ice or the provision of cold storage rooms. S. 17.

(i) Small and medium scale industries in non-municipal areas. S. 18.

(j) Paddy Milling. S. 19.

(k) Export industries. S. 20.

(l) Performance of a contract entered into with the Mahaveli Authority. S. 22A.

(m) Engaging solely in property development project. S. 22B.

(n) Import substitution industries and pioneering industries. S. 22C.

(o) Expansion of an existing industry where a company presently not enjoying a tax holiday is engaged in an activity as would have qualified for a tax holiday.

(p) Independent processing units which are set up to process local agricultural produce.

Withdrawal of the allowance in respect of Qualifying Payment made in the purchase of ordinary shares in Approved Undertakings.

An allowance granted as a deduction from the assessable income of any person in respect of an investment in the purchase of ordinary shares in an approved company will be withdrawn, if

(a) there have been a change of ownership of the shares within five years of purchase: S. 31(7).

(b) the moneys collected on the allotment of the shares have not been utilised for the purposes of the activity of such company for which the approval was granted. S. 31(8).

***(a)* Withdrawal of allowance on change of ownership of shares.**

The allowance granted as a deduction from the assessable income will be withdrawn if:–

(i) a change of ownership occurs by sale, transfer, gift or otherwise excluding the change of ownership by death of the individual who purchased the shares.

(ii) any sum of money in respect of those shares is withdrawn or realised by, or paid to, the person who purchased those shares.

The allowance granted as a deduction will not be withdrawn, if –

(i) the change of ownership occurs by the death of the individual who purchased the shares; or

(ii) by the dissolution of, or the cessation of the business carried on by the company or body of persons which purchased the shares; or

(iii) where the shares are sold, and the proceeds of such sale is used to purchase ordinary shares other than existing shares in an approved undertaking within three months of such sale.

Where there has been any change of ownership additional assessment will be made for the year of assessment in which the allowance was granted. The amount of the additional assessment shall be the difference between the income tax to which the person who has been granted the allowance would have been liable if such allowance was not granted.

(b) **Withdrawal of allowance where the company has not utilised moneys collected for the purposes for which the company was approved.** S. 31(8).

Where it is found that a company which was approved by the Minister as an approved undertaking has not utilised the moneys collected by the issue of shares for the purposes of the activity of such company for which the approval was granted, within two years of the date on which the moneys were collected, the Minister may withdraw the approval from the date specified on such order. Where the approval granted has been withdrawn the allowance granted as deduction from assessable income of any person in respect of such qualifying payment will be withdrawn and an additional assessment will be made. The amount of the additional assessment shall be the difference between the income tax to which the person who has been granted the allowance would have been liable, if such allowance has not been granted.

The order published by the Minister in the Gazette may be declared to take effect from a date earlier than the date on which such order is made. S. 31(8).

Example of claim for deduction of Qualifying Payment

The effect on the tax payable on making a qualifying payment is shown in the following examples.

Example I:

The assessable income of a resident individual for the year of assessment 1982/83 is Rs. 300 000. He made no qualifying payments during year ended 31.03.1983.

His liability to income tax is:

	Assessable Income	...	...	Rs. 300,000
Less:	Personal Allowance	...	...	12,000
	Taxable Income ...	...	...	Rs. 288,000
	Income Tax payable			
	Rs. 52,800 at varying rates ...		...	Rs. 15,600
	Balance Rs. 235,200 at 55% ...		...	129,360
				Rs. 144,960

Example II:

The assessable income of a resident individual is Rs. 300,000 for the year of assessment 1982/83. He made the following qualifying payments during year ended 31.03.1983.

(a) Life Insurance Premia	...	...	Rs. 12,000
(b) Shares in approved companies	...	...	75,000
(c) Housing Loan repayment	...	...	15,000
			Rs. 105,000

Computation of liability to Income Tax is as follows:

Assessable Income	...	...	Rs. 300,000
Less: Personal Allowance	...	Rs. 12,000	
Qualifying Payments restricted to $\frac{1}{3}$rd of Assessable Income	...	100,000	112,000
Taxable Income ...	...	...	Rs. 188,000
Income Tax Payable:-			
52,800 at varying rates	...	...	Rs. 15,600
Balance 135,200 @55%	...	...	74,360
Income Tax Payable	...	...	Rs. 89,960

Example III:

The details of income and qualifying payment of the resident individual is same as in Example II. Assume that this resident individual made a further investment of Rs. 250,000 in shares in an approved company with a capital of over five hundred million rupees:

Computation of Liability:

Assessable Income ...	...	...	Rs. 300,000
Less: Qualifying payment—restricted to $\frac{1}{3}$rd of assessable Income	...	Rs. 100,000	
Qualifying payment deductible without restriction	...	250,000	350,000
Balance qualifying payment carried forward for set off in the year of assessment 1983/84	...	...	Rs. 50,000
Income Tax Payable	...	...	Rs. NIL

2. **Business Carried on by a Company:**

In order to promote economic growth the Government has provided substantial tax concessions to encourage the formation of limited liability companies. The company form of business organisation provides the facility to build up of reserves for expansion and for the development and maintenance of the company. A measure of fiscal control exists in the case of private companies in the build up of reserves but such control is not operative where the reserves are for the current requirements of the company and for the development and maintenance of the company's business.

The advantages of the company form of business are:-

"The general advantage of the Company form of organisation over its non-corporate rivals take on a new dimension in the context of developing economies; its separate existence plays a positive role in building up reserves; its Corporate structure affords investment opportunities for individual savers; its size makes it possible for the economies of large scale production; its salaried officials provide the necessary management and other skills." – Taxation Commission Report 1968.

The policy of the government is to actively encourage the formation of corporate form of business. The policy of the government as outlined by the Minister of Finance:

"......While we concentrate on investment and growth, the government is equally conscious of the need to ensure that the fruits of this increased prosperity are shared by as large a number of people as possible ...... The company form of business organisation should be actively encouraged to attract the small investor into its fold. To achieve this end, not only should investment in equity share capital be made more attractive through the prospect of better yields, but the tax concessions to companies should be geared to induce corporate business to become more broad based. Fiscal policy should be designed to reactivate the capital market which is a valuable adjunct of the financial system in ensuring the flow of funds for investment." Budget Speech 1980.

The objectives of the government has found expression firstly in the concept of –

(a) A small company;
(b) A People's Company;
(c) Quoted Public Company.

and secondly in providing substantial tax concessions to company form of business undertakings by providing tax incentives:

(a) Deductibility of the formation expenses of a limited liability company. S. 23(1)(o).
(b) Capital gains arising to a proprietor or a partnership on conversion into a Quoted Public Company. S. 14(a)(xiv).
(c) Investment in ordinary shares in approved companies are treated as qualifying payments. S. 31(2)(d).
(d) Exemption of capital gains on the transfer of shares in Quoted Public Companies: S. 14(a)(xiii).[1]
(e) A reduced rate of taxation to a Quoted Public Company.[1]
(f) Exemption from withholding tax in respect of dividends paid by Quoted Public Companies. S. 38(1).[1]
(g) Exemption from withholding tax in respect of dividend declared by a resident company out of a dividend received from a Tax Holiday Company. S. 38(i)(b).
(h) Exemption of dividends in the hands of shareholders of Tax Holiday Companies for the specified period. S. 11(C).[1]
(i) Providing for tax holiday only to company or a quoted public company form of business organisation in respect of the following:
    (i) A ten year tax holiday for a quoted public company operating hotels for tourists. S. 16A.
    (ii) A tax holiday up to 31.03.1985 to companies carrying on Agriculture, Sericulture, Animal Husbandry and Fishing undertakings. S. 17.

---

1. 24 of 1980.

(iii) A five year tax holiday for a quoted public company carrying on Mahaveli Contracts. S. 22A.

(iv) A ten year tax holiday for quoted public companies undertaking Urban development projects. S. 22B.

(v) A five year tax holiday for import substitution and pioneering industries to a quoted public company. S. 22C.

(vi) A ten year tax holiday for a quoted public company undertaking non-traditional large scale agriculture. S. 22E.

(vii) A five year tax holiday to company undertaking manufacture and export and for providing services for payment in foreign currency. S. 20.

(viii) Tax holiday for companies in the Investment Promotion Zone.

Number of Persons who can form a Company:

Any seven or more persons, or where the company to be formed is to be a private company, any two or more persons, or where the company to be formed is a peoples company, any fifty or more persons, for any lawful purpose may, by subscribing their names to a memorandum of association and otherwise complying with the requirements of the Companies Act in respect of registration form an incorporated company with or without limited liability: Section 2 Companies Act No. 17 of 1982. A family business may be carried on as a private limited liability company with a minimum of two shareholders.

Conversion of Proprietorship or Partnership into limited liability Companies.

There may be business and tax advantages in the conversion of a proprietorship or a partnership business into a limited liability company. Tax-wise, the main consideration would be whether the same level of income would be maintained in future. Since the cost of formation of a limited liability company is an allowable deduction, the cost of formation may not be a deciding factor in the conversion of propietorship or partnership into a company.

The advantage of a company form of business orgahisation will depend on the size and the regularity of the income of the company and its shareholders and the extent to which profits may be retained in the company. A corporate form of business may be disadvantageous unless withdrawals can be made in the form of salary and other deductible expenditure. The incidence of income tax as shown in the Tables in this Chapter should be a guiding factor.

Apart from tax advantages that accrue to individuals there are other business advantages that accrue in carrying on business as a company. The decision to incorporate a limited liability company must weigh all advantages and disadvantages.

Deductibility of Preliminary Expenses of Company:

The formation expenses of the Company which are called the Preliminary Expenses are considered capital expenditure in accountancy practice and did not rank as deduction in computing profits liable to income tax. Preliminary expenses will include the following:-

(a) Lawyers fees for drawing up Memorandum and Articles of Association;

(b) Fees payable for the registration of the Company and the stamp duties on the Memorandum and Articles of Association and on the nominal share capital;

(c) Expenses incurred in printing Memorandum and Articles of Association of the Company;

(d) Cost of Share Register, the Seal of the Company and other books which a Company is required to maintain;

(e) Any other expenses incidental to the formation or promotion of the Company.

The Inland Revenue Act provides for the deduction of the formation expenses of the Company in computing the profits. S. 23(o). At the Company rate of taxation at 50% it can be said that the real cost of Company formation or promotion is reduced by one half.

Investment in shares in approved Companies are considered qualifying payments:

Every person subscribing to the ordinary capital of an approved Company will be able to deduct the cost of purchase up to one third of his assessable income in an year of assessment. Where the investment is in ordinary share capital other than existing shares in a company engaged in Tourist Hotel project or property Development project or in Large Scale non-traditional agriculture with capital of over five hundred million rupees will qualify for deduction from assessable income without any limit with the facility to carry forward the excess to subsequent years of assessment. There would be substantial tax savings to investors depending on the rate of tax at which such person is liable in that year of assessment.

This concession will enable promoters of companies to induce subscribers to take up ordinary share capital in the Company. A private limited liability company can also be floated by family members and where such a company is approved as an approved undertaking the amount invested by them would qualify for deduction as qualifying payment.

Where approved companies are also entitled to tax holiday, the investors will have the advantage of the deduction from assessable income to reduce their tax liability in an year of assessment and would be able to receive tax free income during the specified tax holiday period.

Small Company:

A small company is a company which is –

(a) a company resident in Sri Lanka;

(b) the issued capital of which does not exceed rupees five hundred thousand throughout the year of assessment;

(c) which has not reduced its capital on or after November 15. 1978;

(d) which was not formed on or after November 15, 1978 by the reconstruction of an existing company or by the acquisition of any plant, machinery or fixtures or building of an existing company. S. 33(2)(b).

A small company is liable to income tax at a concessionary rate of income tax if –

(a) EITHER such a company is a small company throughout that year of assessment;

(b) OR where such a company was incorporated in that year of assessment is a small company from the date of incorporation.

A small company which is a quoted public company will enjoy the concessionary rate of tax applicable to a quoted public company where its taxable income exceeds Rs. 250,000.

Tax Rates applicable to a Small Company which is not a Quoted Public Company: [2]

Rs.	50,000	@ 20%
	100,000	@ 30%
	100,000	@ 40%
Balance of Taxable Income		@ 50%

Tax Rates applicable to a Small Company which is a Quoted Public Company [2]

Rs.	50,000	@ 20%
	100,000	@ 30%
Balance of Taxable Income		@ 40%

Dividends declared by a Small Company:

A small company which is not a quoted public company is liable to income tax on the aggregate amount of the dividends declared out of the profits on which the taxable income of the company is computed for any year of assessment. The rate of tax the small company is liable to pay on dividends is 20%.[1]

A small company which is a quoted public company is not liable to tax on dividends paid and can pay dividends gross to its shareholders.

Peoples Company:

Broadbased Resident companies termed as Peoples Companies are entitled to concessionary rate of income tax on their profits at 40% where such a company furnishes evidence to the satisfaction of the Assessor that:

(a) it is not a private company within the meaning of the Companies Act.

(b) the number of shareholders exceed one hundred and the nominal value of the shares does not exceed Rs. 10;

(c) any person may invest in one or more shares in the Company at any allotment of shares by the Company or in the open market;

1. 24 of 1980. 2. 27 of 1982.

(d) that no person either individually or together with his wife or minor children, holds either directly or through nominees, more than 5% of the issued share capital;

(e) that there are three or more Directors each owning one or more shares;

(f) that none of the Directors of the Company holds office as Director of any other People's Company; and

(g) that no other Company holds any share either or through nominees.

In order to qualify as People's Company all the foregoing conditions must prevail throughout the year preceeding the year of assessment or if the Company was incorporated in that year of assessment from the date of incorporation to the end of that year of assessment. S. 33(i)(iii).

Dividends declared by a People's Company:

A People's Company is liable to income tax to a sum equal to 20% of the aggregate amount of the gross dividends declared out of the profits on which the taxable income of the company is computed for any year of assessment.

A People's Company which is a quoted public company is not liable to tax on dividends and can pay dividends gross to its shareholders.

Quoted Public Company:[1]

A quoted public company is a company which is –

(a) resident in Sri Lanka;

(b) satisfies the Assessor that it is a company the shares of which are quoted in the official list published by the:-

(i) Colombo Brokers' Association; or

(ii) such other body approved by the Minister as a body performing functions of the Colombo Brokers' Association.

The Ministry of Finance has laid down that tax holiday will be approved only to quoted public companies which offer not less that 40% of the share capital for public subscription. However, where 40% of the share capital has been offered to the public and has not been fully subscribed may be taken up by the promoters and in such circumstances the tax holiday will be approved although the amount taken by public subscription is less than 40%.

A company may be able to obtain a quotation from the Colombo Brokers' Association (subject to the recommendation of the share sub-committee as to the reasonable percentage of the issued capital to be made available to the public) by offering less than 40% of the issued capital to the public Such a company will by definition be a quoted public company and will be entitled to reduced rate of taxation, will be able to declared dividends gross and transfer of its shares will not attract capital gains tax. Such a company will not be entitled to tax holiday.

A number of tax concessions apply to quoted public companies. They are:-

1 24 of 1980

(a) **A reduced rate of Company Tax.**

A quoted public company is liable to income tax at 40% on its taxable income. A quoted public company will therefore enjoy a reduction of 10% on the rate of tax applicable to a resident company and have a higher return net of tax which will enable the company to build up its reserve or declare higher dividends.

(b) **Exemption from Dividends tax and no withholding tax on Dividends declared by such companies:**

A quoted public company is not liable to tax on its dividends. S. 33(1A)(a). A quoted public company can therefore declare dividends gross to its shareholders. S. 38(1)[1]

(c) **Exemption from Income Tax on Capital gains arising on transfer of shares in quoted public company.** S. 14(a)(xiii)[2]

The capital gains realised on the passing of shares in a quoted public company on or after November 15, 1979 is not liable to income tax. Transactions in shares in quoted public companies may be entered into without any liability to capital gains tax and is likely to promote an active share market.

(d) **Exemption of capital gains in the conversion of a business carried on by a proprietorship or a partnership into a quoted public company.** S. 14(a)(xiv).

Any capital gains arising upon the conversion of a business carried on by an individual either solely or in partnership with others into a quoted public company on or after November 15, 1979 is exempt from income tax provided that any assets acquired by the business prior to March 31, 1977 must be valued at a price not exceeding the market value of those assets on March 31, 1977

(e) **A specified period of tax holiday to following undertakings carried on by a quoted public company.**

(i) a ten year tax holiday for certain undertakings related to tourist hotels with equity capital of not less than one hundred million rupees. S. 16A[1]

(ii) a five year tax holiday for quoted public company engaged solely in the performance of contracts entered into with the Mahaveli Authority. S. 22A[1]

(iii) a ten year tax holiday for a quoted public company undertaking pioneering and import substitution industries. S. 22C[1]

(iv) a ten year tax holiday for a quoted public company engaged solely in property development. S. 22B[1]

(v) a ten year tax holiday for a quoted public company engaged solely in non-traditional agriculture and processing the produce of such cultivation with a paid up equity capital of over rupees one hundred million. S. 22D[2]

---

1. 24 of 1980. 2. 40 of 1981.

3. Tax Incentives for Housing:

Substantial tax concessions and tax holiday have been provided to encourage investment in housing projects to increase the housing stock in Sri Lanka. The Inland Revenue Law provides the following incentives for housing.

(i) Exemption of profits from income tax on construction and first sale of houses. S. 21.

(ii) The exemption from income tax in respect of the net annual value. S. 12(1)(a);

(iii) Exemption of income from rent in respect of newly constructed house. S. 12(1)(b).

(iv) Exemption of income from rent on conversion of existing houses into two or more places of residence. S. 12(1)(c).

(v) Investment in housing by individuals and employers are treated as qualifying payments. S. 31(2).

(vi) Exemption of capital gains on sale of certain houses. S. 14(i) & (ii).

(I) Exemption of profits from the construction and first sale of certain houses. S. 21.

Exemption from income tax is available to any person who carries on an undertaking for the construction and sale of houses, if

(a) the undertaking has been approved by the Commissioner for National Housing;

(b) the construction of the house or flat was commenced after January 01, 1977; and

(c) the sale is the first sale of that house or flat.

The exemption of profits vary with the area of the house or flat and apply as follows:

(a) Where the floor area of the house or flat does not exceed 1000[1] square feet the entirety, of the profits on sale of such flat or house is exempt from income tax;

(b) Where the floor area of the house or flat is not less than 1000 square feet and does not exceed 1,750[1] square feet, seventy five percent of the profits on the sale of such flat or house is exempt from income tax;

(c) Where the floor area of the house is not less than 1,750 square feet and does not exceed 2000[1] square feet fifty percent of the profits is exempt from income tax.

Ventures in housing projects can be carried on by individuals, partnerships or by companies and will be entitled to exemption of profits as outlined above.

In the case of a limited liability company, investment in equity capital in a company carrying on an undertaking of construction and sale of house or flats will rank as qualifying payment and may be utilised to reduce tax

1. 27 of 1982.

liability of the shareholders. The dividend issued out of exempt income will be exempt from income tax in the hands of the shareholders.

(II) **Exemption of Net Annual Value:** S. 12(1)(a) & (b).

Net annual value in respect of the following is exempt from income tax:

(a) The net annual value of not more than one house owned by, and occupied by or on behalf of an individual is exempt from income tax. S. 12(1)(a).

(b) The net annual value of a newly constructed house the floor area of which does not exceed 3000 square feet, owned and occufied by the owner is exempt from income tax for the year of assessment in which the house was completed and for six years of assessment succeeding that year of assessment. Where the square area of the house constructed does not exceed one thousand five hundred[1] square feet, the net annual value will be exempt for ten years of assessment including the year of assessment in which such house was completed. S. 12(1)(b).

(III) **Exemption of Income from rent.** S. 12(b).

Where a newly constructed house is solely used for residential purposes and in respect of which –

(a) the Rent Act No. 7 of 1972 applies; or

(b) the floor area inclusive of the thickness of the walls does not exceed 3000 square feet.[1]

the income accruing to the owner from such house is exempt from income tax for seven years of assessments including the year of assessment in which the construction of that house was completed.

Where the floor area of such house does not exceed one thousand five hundred square feet[1] the rent income is exempt for ten years of assessments including the year of assessment in which the construction of that house was completed. S. 12(1)(b).

(IV) **Coversion of house into two or more residential units:**

Where a house the income of which is not exempt from income tax is converted into two or more places of residence and each such unit is assessed separately for purposes of rates the income accruing from each such place of residence is exempt from income tax. The period of exemption is determined on the basis of floor area of each residential unit as follows:

(a) Where the floor area does not exceed one thousand five hundred square feet the rent income is exempt for six years of assessment including the year of assessment in which the conversion was effected;

(b) Where the floor area exceed one thousand five hundred square feet and does not exceed two thousand square feet the income from rent is exempt for four years of assessment including the

1. 40 of 1981.

year of assessment in which the conversion was effected. S. 12 (1)(c).

(V) **Investment in housing projects rank as qualifying payments.** S 31

Certain investments in housing projects are considered as qualifying payments which enable the taxpayer to deduct an allowance from his assessable income in computing his tax liability. Following are the investments which are considered as qualifying payments for the purposes of tax rebates from income tax.

(i) Investment made by any person in the purchase of shares other than existing shares, in approved companies engaged solely in

(a) the construction and sale of houses;

(b) development and sale of land for building purposes under any scheme approved by the Minister for Housing;

(c) construction and sale of houses and in the development and sale of land for building purposes under any scheme approved by the Minister.

(ii) Any amount paid by an individual to the government, to any banking institution or to any local authority or any other institution approved by the Minister for Housing

(1) In the repayment of capital of any loan granted on or after April 01, 1973 for the construction of a house or for the purchase either of the first house or of the first site for the construction of the house, while being owner of the house or site.

(2) As monthly payment in respect of any house let on or after April 01, 1973 on rent purchase terms. S. 31(2)(e).

(3) Any amount certified by the Commissioner of National Housing as having been spent by an individual on the construction of a house out of his own cash resources qualify for deduction as a qualifying payment if the cost of construction has not been financed out of any loan from –

(a) the government;

(b) any banking institution;

(c) any local authority;

(d) any other institution approved by the Minister for Housing.

The Commissioner General of Inland Revenue has given a ruling that the certificate from the Commissioner of National Housing is not required to claim relief and the law will be suitably amended. The application for deduction must be made with the following documents :-

(a) certificate of conformity;

(b) copy of approved plan;

(c) bill of quantities and estimates or a statement of cost.

(4) The amount spent by an individual on or after April 01, 1978 out of his own cash resources or from private loans in the purchase of either the –

(a) first house; or

(b) the first site for the construction of a house.

In order to qualify as 'qualifying payment' the cost of purchase should not have been financed out of a loan from –

(a) the government;

(b) any banking institution;

(c) any local authority;

(d) any other institution approved by the Minister for Housing.

(5) Any amount spent by any person in the construction of any house or flat or the cost of purchase of any unit of residental accommodation constructed with the approval of the Urban Development Authority which is comprised in a registered Condominium Property, if

(a) Such flat, house or unit of accommodation is for the occupation of any employee of such person;

(b) the floor area does not exceed 1500 square feet;

(c) an allowance for depreciation has not been claimed. S. 31(2)(l) [1]

The amount deductible is restricted to one third of the assessable income of the employer in the year of assessment in which the cost is incurred. He cannot spread or carry forward any cost of construction, but may be able to incurr the cost of construction over a period and claim the cost incurred in each year of assessment.

Additional Concessions:

(a) An individual is permitted to claim the cost of construction of a house or the cost of purchase of either first house or the first site for the construction of a house, out of his own cash resources, over five years of assessments including the year of assessment in which the cost of construction or cost of purchase of a house or site for construction of a house was incurred and the amount so spread is deemed to be a 'qualifying payment' made in each of those years of assessments. No deduction will be permitted –

(i) In spreading the cost of purchase or construction for more than five years of assessment; and

(ii) Unless such individual is the owner of such house or site in each of the five years of assessments. S. 31(3)

(b) **Cost of Purchase** [2]

The word purchase has been defined to cover a lease of any unit of residential accomodation constructed with the approval of the Urban Development Authority and comprised in a registered condominium property. Provided that –

(a) The lease is for a period of more than fifty years ; and

---

1. 24 of 1980 and 27 of 1982. 2. 27 of 1982.

(*b*) The consideration for the lease was paid in full at the time the lease was entered into.

Such a lease is deemed to be a purchase of a house and accordingly the repayment of loans taken to pay for the lease or where the entire lease consideration was paid in cash will be treated as a 'qualifying payment' deductible from the assessable income of an individual.

Joint Purchase or Loan Repayment by a Husband and Wife

With the change in the law providing for assessment of a husband and wife separately on their income, the question of allocation of deductions in respect of qualifying payments has caused some problems. The Commissioner General has given a ruling setting out the basis of deduction where the husband and wife are jointly parties to a loan or purchase in respect of construction of house or purchase of a house or site as follows:

(a) **Purchase of a house or building block.** S. 31(2)(e) & (g).

In the case of a joint purchase of a building block or a house by the husband and wife each individual will be entitled to claim relief on the investment made by that individual.

(b) **Construction of a house.** S. 31(1)(e) & S. 31(1)(f).

Where a house is constructed jointly by the husband and the wife relief will be given on the investment made by each individual. Where a house is constructed by one spouse on the land owned by the other, relief will be granted in the year of construction to the spouse incurring the expenditure. He will not be entitled to spread the expenditure over five years under section 31(3).

(VI) **Exemption of Capital Gains on Sale of house used for residential purposes.**

The exemption from capital gains applies to individuals on the

(a) Sale of a house owned by him; and

(b) On the sale of a house constructed by him.

(a) **Sale of a house owned by an individual.** S. 14(a)(ii).

The capital gains arising on the sale of a house owned by an individual is exempt from income tax, if

(*a*) Such house was used solely for residential purposes,

(*b*) That individual has not sold any other house on or after April 01, 1978. The restriction does not apply to the sale of any house constructed and sold by such individual.

In respect of houses which are co-owned the Commissioner General of Inland Revenue has given a ruling that the exemption will apply to a co-owner who sells his share in the house. The co-owner however, will not be entitled to relief from capital gains on any subsequent sale of a house or a share of a house. The exemption will apply where the sale of the share of the house on which relief is being claimed is the first sale of a house or a share of a house made on or after April 01, 1978, other than a house constructed and sold by him.

Tax concessions on the exemption from capital gain is provided to encourage active investment in housing stock. An individual who is in possession of a residential house will be able to obtain capital by sale of the house, free from any capital gains tax. He may, either by purchasing another house or by purchasing of a site for construction of a house and constructing a house, be able to obtain tax relief for five years of assessments on the cost incurred. The deduction on account of qualification will however. be limited to one third of the assessable income.

4. **Tax holiday for the Tourist Industry:**

Tax holiday for specified period is allowed to undertakings carried on by –

(a) any person in operating hotel for tourists. S. 16(a).

(b) to a quoted public company operating hotel for tourists. S. 16A[1]

(c) any person operating hotel for tourist constructing additional bed rooms. S. 16B.[1]

(d) any person providing buildings of the operation of hotel for tourists. S. 16(b).[1]

(a) **Any person operating hotel for tourists.** S. 16(a).

Tax holiday is allowed to an undertaking operating hotel for tourists carried on by any person for a period of five years reckoned from the date on which such undertaking commenced to carry on business, if:–

(i) the undertaking was commenced on or after April 01, 1966;

(ii) the undertaking is approved by the Minister of Finance by order published in the Gazette prior to March 31, 1983[2] on the recommendation of the Tourist Board.

(b) **A Quoted Public Company operating hotel for tourists.** S. 16A.

Tax holiday is allowed to a quoted public company carrying on an undertaking of providing hotel for tourists for a period of ten years calculated from the date such undertaking commenced to carry on business, if:–

(a) the undertaking of operating hotel for tourists is carried on by a quoted public company;

(b) that the subscribed equity capital of which is not less than one hundred million rupees;

(c) that the undertaking was approved by the Minister of Finance by order published in the Gazette prior to March 31, 1983[2] on the recommendation of the Tourist Board.

The Minister of Finance will require that at least forty percent equity capital should be made available for public subscription for the granting of tax holiday. However, where such shares are not fully subscribed by the public, these can be taken over by the promoters.

---

1. 24 of 1980. 2. 27 of 1982

(c) **Any person operating hotels for tourists constructing additional bed rooms**. S. 16B.[1]

Any person who carries on an approved tourist hotel undertaking will be entitled to a five year tax holiday on profits attributable to the additional bed rooms. If:–

(a) such person constructs additional bed rooms after November 15, 1979 for use by tourists;

(b) that the construction of additional bed rooms has been approved by the Minister of Finance by order published in the Gazette prior to March 31, 1983[2] on the recommendation of the Tourist Board.

The tax holiday will apply only to the profits attributable to the additional bed rooms constructed after November 15, 1979. For example where the existing hotel had in operation 300 rooms, constructed an additional 100 rooms the portion of the profits exempt from income tax for a period of five years is $\frac{100}{300}$ of the profits of the undertaking.

(d) **Any person providing buildings for the operation of hotel for tourists**. S. 16(b).

Any person carrying on an undertaking for providing buildings for the operation of hotel for tourist is entitled to a tax holiday for a period of five years calculated from the date on which such undertaking commenced to carry on business, if:

(a) Such undertaking provides building for use to an undertaking for operating hotel commenced prior to April 01, 1966; and

(b) the undertaking was approved by the Minister of Finance by order published in the Gazette prior to April 01, 1980.[1]

Approvals are not given by the Minister of Finance for an undertaking of providing building for the operation of hotel for tourists after April 01, 1980. All undertakings which were approved prior to April 01, 1980 will continue to enjoy tax holiday from the date such undertaking provided buildings for operating hotels for tourists.

Additional Tax Incentives:

In addition to the tax holiday for specified period further incentives are available. They are –

(i) **Exemption of Dividends**:

Any dividends paid by a company which is entitled to tax holiday during the period of the tax holiday or within one year thereafter is exempt from income tax in the hands of the shareholders. S. 11(b).

Where such a dividend is received by a shareholder which is a company, the dividend declared by such company in the year of assessment in which such company received the dividend or within one year thereafter is exempt from income tax in the hands of its shareholders. S. 11(c).[1]

---

1. 24 of 1980. 2. 27 of 1982.

(ii) **Deduction of Capital Expenditure.**

An approved tourist hotel undertaking can deduct the sum expended in the purchase of any furniture, utensils, or articles for use in such undertaking. S. 23(1)(d)(i).

An undertaking which has not been approved by the Minister as an approved tourist hotel undertaking undertakes the renovation or making additions or improvements to existing building or the erection of building and has been approved by the Minister of Finance by order published in the Gazette on the recommendation of the Tourist Board for this purpose is entitled to deduct the full cost of purchase of any furniture, utensils or articles for use in such undertaking S. 23(1)(d)(i)(b).

(iii) **Management Fees paid to a non-resident person.** S. 15(k).[1]

Any management fees calculated as a percentage of the gross profits paid to a non-resident person by a quoted public company carrying on a hotel undertaking is exempt from income tax provided such payment to such non-resident person is approved by the Minister of Finnace on the recommendation of the Tourist Board.

(iv) **Non-Rresident Contractors constructing building for operation tourist hotels.** S. 22(b).

The profits and income accruing to any person from the performance of any contract entered into with the proprietor of an undertaking carried on by any person for the operation of hotel for tourists: S. 16(a): and an undertaking for providing buildings for the operation of hotel for tourists: S. 16(b): is exempt from income tax, where such contracts have been entered into prior to November 12, 1981.[2]

(v) **Exemption of Capital gains.** S. 14(a)(xiii)[1]

Capital gains arising on the disposal of shares in a quoted public company is exmpted from income tax. Capital gains arising on disposal of shares in a tourist hotel company which is quoted in the official list published by the Colombo Brokers' Association will be exempt from income tax.

Any person owning shares in tourist hotel companies which are quoted public companies may dispose of the shares without attracting capital gains tax.

(vi) **Pruchase of shares in Approved Tourist Hotel Companies are qualifying payment for investment relief.** S. 31(2)(d).

Shareholders who invest in approved tourist hotel undertakings are entitled to investment relief as such investment is regarded as 'qualifying payment'. The Minister of Finance approves tourist hotel undertakings as approved undertakings for the purpose of investment relief.

The amount of the deduction from the assessable income is restricted to one third of the assessable income of any person in the year of assessment in which such investment is made.

---

1. 24 of 1980. 2. 27 of 1982.

In the case of tourist hotel companies which are quoted public companies in which the capital outlay exceeds five hundred million rupees, any person making an investment in ordinary shares other than existing shares is entitled to deduct the full cost of such investment from the assessable income and the excess if any can be carried forward for set off in the next succeeding years.

The approved undertaking status will be available for a period of five years from the date of the first issue of shares. All new issue of shares within the five years are considered as qualifying payments.

Rebate in income tax in respect of companies carrying on Tourist Hotel projects: S. 85.

A company which was approved prior to the April 01, 1976, is entitled to a rebate of 50% of the non-refundable tax in respect of the profits of the tourist hotel undertaking for the period of FIFTEEN YEARS immediately following the FIVE YEAR TAX HOLIDAY.

The non-refundable tax in respect of the profits of the undertaking will be, in the case of a

Resident Company –

the non-refundable tax less reliefs for Double Taxation and Commonwealth tax relief.

Non-Resident Company –

the refundable tax including the 5% additional levy and excluding the tax the company is liable on its remittances less relief for Double Taxation and Commonwealth Tax.

Example:

XYZ Ltd. a resident company carrying on the business of textile manufacture commenced to operate a hotel for tourists. The company received approval and its profits were exempt from 01.04.1970 to 31.03.1975. During the year ended 31.03.1979, the company made a profit in respect of the textile business Rs. 400,000 and the profits of the hotel business was Rs. 200,000. The company declared a dividend of Rs. 150,000 out of the profits of the textile business.

Computation of liability:

		Rs.		Rs.
Profits from textile manufacture	... ...	400,000		
Profits from Tourist Hotel	... ...	200,000		
Tax payable at 50% of the taxable income	...	600,000	=	300,000
Tax payable on dividends at 20%[1] of Rs. 150,000	...		=	30,000
Gross tax payable	... ...			330,000
Less: Rebate on income tax 50% of Rs. 100,000	...			50,000
Tax payable by the company	... ...			280,000

Where the company is a non-resident company:

Assuming that the particulars in the above example is the same except that the company made a remittance of Rs. 150,000 and did not declare any dividends.

1. 24 of 1980

Computation of liability:

			Rs.
Income tax payable — Rs. 600,000 at 55%	...	...	330,000
Remittance tax – Rs. 150,000 at $33\frac{1}{3}\%$	...	...	50,000
Gross tax payable	...	...	380,000
Less: Rebate $= 200{,}000 \times \frac{55}{100} \times \frac{50}{100}$	...	...	55,000
Tax payable by the company	...	...	325,000

Where the company is entitled to double tax relief the tax rebate is calculated on the net tax after deduction of double tax relief.

5. **Tax Incentive for the Milling of Paddy:** S. 19.

Exemption of profits from income tax is available to undertaking carrying on the business of Paddy Milling commenced on or after 15th November 1977. The exemption will be available from the date of commencement to 31.03.1983. The exemption will be available if the following conditions are satisfied.

(a) the undertaking must have commenced on or after 15.11.1977;

(b) the undertaking must be approved by the Minister of Finance by an order published in the Gazette.[1]

The exemption will not be available:

(a) In respect of the profits on the sale of capital assets;

(b) In respect of income from sources other than the business income of such undertaking; that is the investment income;

(c) If the undertaking was formed by splitting up, reconstruction or acquisition of any business which was previously in existence.

Loss of undertaking of Milling of Paddy during the Tax Holiday period:

Since the entirety of the profits from the undertaking of milling of paddy is exempt from income tax any loss incurred during the tax holiday period cannot be deducted from the profits of any other sources of that person. Any loss incurred by the undertaking for the milling of paddy will first be set off against the exempt profits of the subsequent year of assessment during the tax holiday period. The balance of the loss which cannot be set off against the profits of the subsequent years of assessment of the tax holiday period can be carried forward and set off against the profits from all sources of income for the year of assessment 1983/84 and where the entirety of loss cannot be set off against the profits of the year of assessment 1983/84 the loss can be carried forward for future years of assessment till the loss is fully absorbed.

Paddy Milling carried on by a Company:

Where paddy milling is carried on by a company,

(a) *Dividends:* All dividends declared out of the exempt profits during the period of tax holiday will be exempt from income tax in the hands of the shareholders.

---

1. 27 of 1982.

(b) *Investment Relief:* Investment in ordinary shares in approved Paddy Milling Companies qualify to deduction as qualifying payment up to one third of that persons assessable income in that year of assessment.

6. **Tax Incentive for Small and Medium scale Manufacturing Undertaking.** S. 18.

The business profits of certain small and medium scale undertaking not exceeding Rs. 200,000 is exempt from income tax from the date of commencement to 31.03.1983. The exemption will apply from the date of commencement to 31.03.1983. The exemption will apply to:

(i) an undertaking commenced on or after 15th November, 1977;

(ii) an undertaking approved by the Minister by order published in the Gazette.[1]

(iii) the place of production or manufacture carried on is located outside the administrative limits of a Municipality;

(iv) the capital of the undertaking at any time during any year of assessment between 01.04.1978 to 31.03.1983 does not exceed Rs. 1,000,000. The capital of the business for this purpose will include the aggregate of –

(i) the cost of any building purchased or constructed and of any land, plant, machinery and fixtures purchased for use in that undertaking; and

(ii) the value of the other assets of that undertaking; LESS

(iii) any profits retained in the business.

Profits retained in the business will not be taken into consideration for the purpose of computing the capital of the business.

Exemption will not apply in the following circumstances:

The undertaking will not be entitled to exemption of profits if,

(i) it is an undertaking for the milling of paddy;

(ii) it is an undertaking which was formed by splitting up, reconstruction or acquisition of any business which was previously in existence;

(iii) the production or manufacture is within the administrative limits of a Municipality;

(iv) the capital of the business exeeds Rs. 1,000,000.

(v) profits made on the sale of capital assets of the undertaking;

(vi) the profits are not from the business of the undertaking i.e. to the investment income of the undertaking.

Losses incurred in medium and small scale industrial undertakings. S. 29(4)(b).

Loss incurred by small and medium scale industrial undertakings can be set off against the statutory income of that undertaking during the partial tax holiday period and the balance loss at the end of the tax holiday period

---

1. 27 of 1982.

can be set off from the statutory income from other sources of that person. The rules for the deduction of losses are as follows:

(i) any loss incurred in any year of assessment from the date of commencement of that undertaking up to 31.03.1983, is deductible only from that part of the statutory income of that person from that undertaking which is qualified for the tax holiday;

(ii) the deduction of the loss must be made from the statutory income of that person from that undertaking immediately succeeding the year of assessment in which the loss was incurred; where the entire loss cannot be deducted from such first year of assessment the deduction can be made from the statutory income of the next year of assessment and so on, during the period of tax holiday.

(iii) the loss to be carried forward for set off after the period of tax holiday, that is, for the year of assessment 1983/84 is computed by taking into account:

- (a) any losses which have been set off from the statutory income of the undertaking of that person during the tax holiday period, and
- (b) the aggregate of the exempted profits for the years of assessment subsequent to the year of assessment in which the loss was incurred.

Application of holiday:

Undertakings carried on as proprietorships, partnerships and companies are entitled to the tax holiday. Where the undertaking is carried on by a company, the tax exemption will apply to any dividends declared by the company out of the exempt profits during the exempt period and for one year thereafter. S. 11(1)(b).

Investment in equity shares in approved companies which are small and medium sale manufacutring undertakings qualify for deduction up to one third of that persons assessable income in the year of assessment in which the investment was made. S. 31(2)(d).

7. **Tax Incentives for Non-Resident Contractors**: S. 22.

Exemption of profits from income tax is available to non-resident contractors who have entered into a contract prior to November 12, 1981[1] with:

- (a) the Government of Sri Lanka; or
- (b) any public corporation or institution which is approved by the Minister of Finance for the purpose of exemption; or
- (c) the proprietor of any undertaking for the construction of a hotel for tourists which will be entitled to exemption from income tax for a period of five years.

In order to be qualified for exemption the non-resident person must satisfy the following conditions:

- (a) at the time he entered into such contract, was non-resident person and did not have a place of business in Sri Lanka;

---

1. 27 of 1982.

(b) the non-resident contractor satisfies the Commissioner General that he entered into such contract for the sum stipulated therein on the basis that the 'profits will be exempt from income tax;

(c) must be declared by the Minister of Finance as a person whose services are required for the economic development of Sri Lanka by order published in the Gazette.

Non-Resident contractors are not entitled to exemption of profits on a contract entered into by them after November 12, 1981. Non-resident contractors who have entered into contracts prior to November 12, 1981 will continue to be exempt on their profits and income

8. **Tax Incentives for Agriculture, Sericulture and Animal Husbandry.** S. 17.

The following undertakings carried on by a company incorporated after November 15, 1977 and approved by the Minister of Finance by order published in the Gazette prior to March 31, 1983[1] is exempt from income tax for the period commencing from the date of incorporation and ending on March 31, 1985.[2]

(a) cultivation of land with any plants of whatever description other than tea, rubber, coconut or paddy;

(b) animal husbandry;

(c) sericulture;

(d) any activity referred in (a), (b) and (c) and the processing of such activity;

The exemption will not apply to:

(a) to an undertaking which was in existence prior to 15th November, 1977;

(b) undertaking which was formed by splitting up or reconstruction of any business which was in existence prior to 15th November, 1977;

(c) to the profits on sale of any capital assets of the company;

(d) other income of the company other than profits of its trade or business, i.e. the investment income of the company.

Losses incurred by companies engaged in agriculture, sericulture and animal husbandry:

Since the entirety of the profits of the company's business is exempt from income tax, the company cannot set off any loss incurred in the undertaking of agriculture, sericulture and animal husbandry against other sources of income of the company. Any loss incurred during the exempt period will be set off against the exempt income of the subsequent years of assessment in the tax holiday period. Any unabsorbed loss after setting off against exempt profits of the subsequent years of assessment can be carried forward and claimed as a deduction from the income from all sources of the year of assessment 1983/84, and where the loss is not fully set off in the year of assessment 1983/84 is carried forward for set off in the next year of assessment and so on.

1. 27 of 1982. 2. 40 of 1981.

The period of exemption from income tax in respect of companies engaged in agriculture, sericulture and animal husbandry has been extended to March 31, 1985.[1] Accordingly any balance loss can be deducted from the statutory income of the year of assessment 1985/86. However, appropriate amendment to section 29(4)(b) has not been made and as the law stands the balance loss is deductible from the statutory income of the year of assessment 1983/84.

Investment in Shares:

Investment in ordinary shares other than existing shares in a company engaged in agriculture, sericulture and animal husbandry which have been approved by the Minister qualify for deduction as a qualifying payment. Any person investing in shares in such a company is entitled to deduct up to one third of the assessable income together with the other qualifying payments in the year of assessment in which such investment is made.

Dividends:

Dividends declared out of exempt profits of the company is exempt from income tax in the hands of the shareholders if such dividends are paid during the tax holiday period or within one year thereafter. The dividends paid out of exempt profits will therefore be exempt up to 31.03.1986 in the hands of the shareholders.

9. **Tax Incentives for Large Scale Non-traditional Agriculture.** S. 22D[1]

Exemption from income tax for a period of ten years from the date of commercial production applies to a company which:

(a) is a quoted public company incorporated on or after January 01, 1981;

(b) is engaged solely in cultivating land with any plant of whatever description other than tea, rubber, coconut or paddy;

(c) is engaged solely in the cultivation of land with any plant of whatever description other than tea, rubber, coconut or paddy and the processing of the product of such cultivation;

(d) the paid up equity capital is not less than one hundred million rupees;

(e) is approved by the Minister of Finance by order published in the Gazette prior to March 31, 1983.[2]

The exemption of profits from income tax does not apply to profits and income on the sale of capital assets of the company.

Dividends:

The dividends declared during the tax holiday period and within one year thereafter are exempt from income tax in the hands of the shareholders.

Investments:

Investment in ordinary shares in large scale companies carrying on non-traditional agriculture and which is approved by the Minister as an approved undertaking qualify to deduction as a 'qualifying payment'. In the case of such companies in which the capital outlay does not exceed five hundred million rupees, the investment qualifies for deduction from assessable in-

1. 40 of 1981. 2. 27 of 1982.

come together with other qualifying payments up to one third of that person's assessable income.

Where the capital outlay exceeds five hundred million rupees, the full amount invested qualifies for deduction from the assessable income without any restriction. Any part of the investment which is in excess of the assessable income can be carried forward and deducted from the assessable income of the subsequent years of assessment. S. 31(m)[1]

Capital:

In determining whether a company has a capital of over five hundred million rupees, capital has been defined (S. 18) as the aggregate of

(a) cost of any building purchased or constructed and of any land, plant, machinery and fixtures purchased for use in that undertaking; and

(b) the value of all other assets; LESS the amount of the profits of the undertaking retained for use in that undertaking.

Capital gains:

Capital gains arising on the disposal of shares in large scale non-tradi tional agricultural companies which are quoted public companies is exemt from income tax.

10. **Tax Incentives to Agricultural Undertakings:**

Tax incentives for non-traditional agriculture, sericulture and animal husbandry were discussed in paragraphs 8 and 9 Further tax incentives are available both to traditional and non-traditional agricultural undertakings.

The definition of business is extended to include agricultural undertakings. S. 163. An agricultural undertaking means an undertaking for the purpose of the production of any agricultural, horticultural or animal produce and includes any undertaking for the purpose of rearing livestock or poultry. S. 163.

The extension of the definition of business to agricultural undertaking facilitate the deductibility of all outgoings and expenditure incurred in agricultural undertakings. Apart from deducting all outgoings and expenditure certain capital expendtiure is also deductible in computing the profits from agricultural undertakings. The facility to deduct this expenditure may enable a person to diversify into agricultural sector as the loss in the first few years are available for set off against other sources of income, providing thereby an incentive for a person with substantial profits from other sources to invest in agricultural undertakings and benefit by reduction in their tax liabilities.

Following expenditure is deductible in ascertaining the profits:

(i) Expenses incurred by any person on the opening up of any land for cultivation. S. 23(1)(m)(i).

(a) clearing land of trees, shurbs or undergrowth;

(b) filling up and draining marshy land;

1. 40 of 1981.

(c) terracing;
(d) constructing fences;
(e) constructing access roads and tracks;
(f) constructing irrigation canals;
(g) sinking wells;
(h) preparation of land for planting;
(i) cost of young plants.

(ii) Expenses incurred in cultivating that land with plants. S. 23(1)(m)(ii). The expenses that could be claimed are
(a) maintaining immature areas; and
(b) replanting the land with the same or different plants.

(iii) All expenses incurred in the purchase of livestock or poultry to be reared on that land.

(iv) Expenses incurred in agricultural research for the development of the business of agriculture. S. 23(1)(l).

Exemption of Subsidy or Grant:

Subsidies and grants are paid to the plantation sector agricultural undertakings, which are exempt from income tax. The exemption applies to any subsidy or grant paid from or under:

(a) capital fund of the Sri Lanka Tea Board;
(b) Rubber Replanting Subsidy Fund;
(c) The Coconut Cultivation Board;
(d) Cocoa replanting subsidy scheme.

Although the subsidies are exempt from income tax, the expenditure in respect of which subsidy is granted is deductible in ascertaining the profits of the agricultural undertaking. Thus the expenditure of replanting rubber is expenditure deductible in computing the profit/loss of that undertaking while the subsidy received is exempt from income tax and not taken into consideration in ascertaining the profits.

11. **Tax Incentive for Fishing**: S. 17.

In order to promote investment in fishing a number of tax incentives have been provided.

(a) **Tax holiday for Companies:**

A tax holiday up to March 31, 1985[1] is available to a company incorporated after November 15, 1977 and approved by the Minister by order published in the Gazette prior to March 31, 1983[2] carrying on one or more of the following undertakings:

(i) an undertaking for off-shore or deep-sea fishing. Off-shore fishing would cover fishing within 25 miles of the shore while deep sea fishing would cover fishing beyond 60 miles of the shore.

(ii) an undertaking carrying on off-shore and deep sea fishing and the processing of the produce of such activity;

1. 40 of 1981. 2. 27 of 1982.

(iii) an undertaking for building of fishing boats or for the manufacture of fishing gear, or for the manufacture; and assembly of marine engines;

(iv) undertaking for the manufacture of ice or for provision of cold storage rooms.

The exemption of profits will not apply to profits from the sale of capital assets. A company which was in existence prior to November 15, 1977 or which was formed by splitting up or reconstruction of any business which was in existence prior to November 15, 1977 will not be entitled to tax holiday.

Dividends:

Dividends declared by the company will be exempt from income tax in the hands of the shareholders during the tax holiday period or within one year thereafter.

Investment in Shares:

Investment in ordinary shares, other than existing shares in an approved company carrying on an undertaking for fishing is deductible from a persons assessable income as a 'qualifying payment'. The amount of the deduction, together with other qualifying payments shall not exceed one third of that person's assessable income in that year of assessment.

Losses:

Since the entirety of the profits are exempt from income tax the company cannot set off any loss incurred during the exempt period against other sources of income. Any loss incurred will be set off against the exempt income of the subsequent year of assessment in the tax holiday period. Any unabsorbed loss of the tax holiday period is carried forward and claimed against all sources of income of the year of assessment 1983/84 and where such loss is not fully absorbed it is carried forward for set off in the next year of assessment and so on.

The tax holiday period was extended up to March 31, 1985[1] and the provision regarding set off of loss had not been suitably amended to provide for the set off of unabsorbed loss at the end of the tax holiday period, that is the year of assessment 1985/86.

(b) **Concession regarding deductibility of certain capital expenditure:**

The following expenditure is deductible in ascertaining the profits:

(i) expenses incurred in the purchase of any implement or equipment for any undertaking of deep-sea or off-shore fishing carried on by any person: S. 23(1)(d)(ii);

(ii) following expenditure in commencing inland fisheries projects:

1. the construction of tanks or ponds;
2. clearing and preparation of any inland waters for the rearing of fish;

1. 40 of 1981.

3. expenditure in the purchase of fish for rearing in the tanks or ponds or inland waters. S. 23(1)(m).

(iii) Expenditure in research connected with fishing.

(c) **Exemption of Subsidy:**

Any subsidy granted by the Ministry of Fisheries for the purchase of fishing boats, marine engines, fishing gear and other fishing equipment is exempt from income tax. S. 13(c).

12. **Tax Incentives for Exports and the provision of Services for payment in foreign exchange.** S. 20.

A company incorporated on or after April 01, 1972 and approved by the Minister after November 15, 1978 but prior to March 31, 1983[1] by order published in the Gazette for,

(a) the manufacture of any commodities; or

(b) the provision of services for payment in foreign exchange,

is entitled to exemption of its export profits and income for a period of five year reckoned:

(a) from the date on which the Company made its first exports; or

(b) from the date on which the Company commenced to provide services for payment in foreign exchange.

The exemption will not apply where –

(a) the undertaking was formed by the splitting up or reconstruction of any business previously in existence; or

(b) any part of the export turnover of that undertaking arose in consequence of the amalgamation of the whole or a part of the trade or business of any other undertaking with the trade or business of that undertaking.

Export Profits:

The export profits that is exempt from Income Tax is arrived at by applying the following formula. S. 20(2)(a).

$$\text{Export Profits} = \text{Total Profits} \times \frac{\text{Export Turnover}}{\text{Total Turnover}}$$

Export Turnover:

Export turnover does not include the following:

(a) any amount received or receivable by sale of capital assets;

(b) any amount received or receivable by sale of gems;

(c) amount received or receivable from the export of:

Black tea in bulk
Crepe rubber
Sheet rubber
Scrap rubber
Coconut oil
Dessicated coconut

1. 27 of 1982.

Copra
Fresh coconuts
Coconut fibre

or such other commodity as may be specified by the Minister as published in the Gazette.

(d) amounts received in respect of sources of income other than the profits of trade, business, profession or vocation.

Total Turnover:

In computing total turnover the following are excluded:

(a) any amount received or receivable by sale of capital assets;

(b) any amount received or receivable from the sale of gems;

(c) any profits or income other than profits of any trade, business, profession or vocation;

Dividends:

Dividends paid by the company out of the exempt income is not liable to income tax in the hands of the shareholders. The exemption will apply to dividends declared during the tax holiday period and for one year thereafter.

Investment in shares of the Company:

An investment in ordinary shares, other than existing shares in an approved company engaged in exports, or providing services for payment in foreign currency qualify for deduction from a person's assessable income, in the year of assessment in which the investment is made. The amount of the deduction, together with other qualifying payments of such person is restricted to one third of the assessable income.

Deductibility of Certain Expenditure. S. 24(c) and (f):

The following expenditure which is incurred outside Sri Lanka solely in connection with the promotion of any services for payment in foreign currency is permitted to be deducted in ascertaining the profits of any trade, busines, profession or vocation:

(a) expenditure incurred in travelling outside Sri Lanka; and
(b) cost of advertising expenditure outside Sri Lanka.

Exemption of the increase in export profits of export undertakings in existence prior to April 01, 1972. S. 20(1A).[1]

Any undertaking which was in existence prior to April 01, 1972 is entitled to exemption from income tax on the increase in export profits over the average of its exports profits of the three years preceeding the selected date, if.-

(a) such undertaking commenced to carry on its trade or business on a day prior to April 01, 1972;

(b) the undertaking has been approved by the Minister under section 7 A of the Inland Revenue Act No. 4 of 1963 as an undertaking

1. 40 of 1981.

capable of making export of commodities or of providing services for the payment in foreign currency and approved by order published in the Gazette prior to April 01, 1982;

(c) that no part of the export tourover of the undertaking arose in consequence of the amalgamation of the whole or part of the trade or business of that undertaking;

(d) that a claim in writing has been made by selecting a relevant date which is not earlier than April 01, 1965 and not later than April 01, 1974;

The selection of this relevant date is entirely left to the choice of the person making the claim and could make the claim which will give the best advantage.

Example:

AB Ltd. a company incorporated in 1960 was carrying on the business of exporting Tea. In 1964 it also undertook the export of batiks and curios and the export profits on batiks and curios are as follows:

		Rs.	*Cumulative total for three years* Rs.	*Average for three years* Rs.
Year ended	31.03.1965	12,000		
	31.03.1966	15,000		
	31.03.1967	8,000	35,000	11,666
	31.03.1968	5,000 (Loss)	18,000	6,000
	31.03.1969	12,000	15,000	5,000
	31.03.1970	16,000	23,000	7,666
	31.03.1971	20,000	48,000	16,000
	31.03.1972	10,000	46,000	15,333
	31.03.1973	17,000	47,000	15,666
	31.03.1974	18,000	45,000	15,000

It will be observed that the most advantageous date to select is 31.03.1969, as this will give the company highest possible relief. Accordingly, the period of exemption will apply from the year of 1970/71 to the year of assessment 1974/75. The profits exempted will be as follows:

	Rs.	Rs.
Year of assessment 1970/71.. ...Export profits	16,000	
Standard profits	5,000	
Profit exempted from taxation		11,000
Year of assessment 1971/72.. Export profits ...	20,000	
Standard profits	5,000	
Profit exempted from taxation		15,000
Year of assessment 1972/73 Export profits ...	10,000	
Standard profits	5,000	
Profits exempted from taxation		5,000

Year of assessment 1973/74	Export profits	..	17,000	
Standard profits	.. ..	..	5,000	
Profit exempted from taxation	..	..		12,000
Year of assessment 1974/75	Export profits	..	18,000	
Standard profits	.. ..	..	5,000	
Profits exempted from taxation	..	..		13,000
Total profits exempted for the five years	..	..		56,000

13. **Tax Incentives for pioneering and Import substitution Industries.** S. *22C.*

Pioneering and Import substitution industries are entitled to a five year tax holiday if such a company satisfies the following conditions:

(a) that the company is a quoted public company;

(b) the undertaking is approved by the Minister of Finance as essential for the economic progress of Sri Lanka by order published in the Gazette prior to March 31, 1983;[1]

(c) the undertaking was not formed by splitting up, reconstruction or acquisition of any business which was previously in existence.

The exemption will not apply to profits on sale of capital assets of the company.

The Minister of Finance has laid the following further conditions for the grant of approval of tax holiday to pioneering and import substitution industries:

(a) that the undertaking should be engaged in the production, manufacture or assembly of goods or commodities or in the processing of local agricultural produce;

(b) the undertaking should be in a position to establish a minimum of 25% net savings in foreign exchange as is certified by the relevant Ministry;

(c) the undertaking should ensure that a minimum of fifty persons will be employed;

(d) the undertaking must be recommended by the relevant Minister or authority.

Dividends:

Dividends declared and paid out of exempt profits during the tax holiday period and within one year thereafter will be exempt in the hands of the shareholders.

Capital Gains on disposal of shares:

Capital gains arising on the disposal of shares in a quoted public company carrying on pioneering and import substitution industries is exempt from income tax. S. 14 (a) (xiii).[2]

---

1. 27 of 1982 2. 24 of 1980.

Investment:

Investment in ordinary shares other than existing shares in an approved company carrying on pioneering or import substitution industries is a qualifying payment'. Any person investing in ordinary shares of such company is entitled to deduct the amount invested, together with other qualifying payments made by him up to one third of his assessable income, in the year of assessment in which the investment was made.

14. **Tax Incentives for Property Development.** S. 22B[2]

A ten year tax holiday applies to a company which:-

(a) is incorporated on or after November 15, 1979;

(b) is a quoted public company or becomes a quoted public company within two years from the date on which it commences to carry on business;

(c) is engaged in property development projects which are approved by the Minister of Finance by order published in the Gazette prior to March 31, 1983[1] on the recommendation of the Urban Development Authority.

The company will be exempt from income tax for a period of ten years from the date on which such company commences to carry on business. The company will not be entiled to exemption on the sale of any capital assets of the company.

On the basis of the guideline for approval for tax holiday, the company must offer more than forty percent of the equity for public subscription and where the shares offered for public subscription are not fully taken up by the public such shares may be allotted to the promoters.

Dividends:

Dividends declared out of exempt profits during the tax holiday period and within one year thereafter are exempt from income tax in the hands of the shareholders.

Investment:

Investment in ordinary shares of approved Property Development Companies qualify for deduction from the assessable income of the person making the investment in that year of assessment.

The amount of the deduction from the assessable income of any person making an investment in shares, together with any other 'qualifying payment' made by such person, is restricted to one third of such person's assessable income.

In the case of investment in shares in Property Development Companies with a capital of over five hundred million rupees, the total amount invested can be deducted from that person s assessable income without any limitation. Where the total investment made is in excess of the assessable income of that year of assessment, the excess can be carried forward and claimed against subsequent year of assessment and so on till the total amount investment is set off in full.

---

1. 27 of 1982. 2. 24 of 1980.

The Property Development Company in which the capital exceeds five hundred million rupees means, the aggregate of:

(a) the cost of any building purchased or constructed and of any land, plant, machinery and fixtures purchased, for use in that undertaking; and

(b) the value of the assets of that undertaking; LESS

(c) any profits of that undertaking retained for use in that undertaking. S. 18(5).

Capital Gains:

Capital gains arising on the disposal of shares in a Property Development Company which is a quoted public company is exempt from income tax S. 14 (a)(xiii).[1]

15. Tax Incentive for Mahaveli Contractors. S. 22A[1]

A five year tax holiday applies to:-

(a) a quoted public company incorporated after November 15, 1979;

(b) a quoted public company engaged solely in the performance of any contract entered into with the Mahaveli Authority;

(c) the contract is approved by the Minister of Finance by order published in the Gazette prior to March 31, 1983[2] on the recommendation of the Mahaveli Authority.

The exemption will be avaliable for a period of five years calculated from the date on which the first of any such contracts was entered into by such company. The profits arising to the company on the sale of any capital asset owned by the company is not exempt from income tax.

Dividends:

Dividends declared out of exempt profits during the tax holiday period and within one year thereafter is exempt from income tax in the hands of the shareholders.

Investment:

Investment in the ordinary shares other than existing shares of an approved company engaged in the performance of Mahaveli Contract is a 'qualifying payment'. The amount of the deduction of any person making investment in shares, together with any other qualifying payments made by such person is restricted to one third of such person's assessable income in that year of assessment.

Capital Gains:

Any capital gains arising of the disposal of shares in a quoted public company engaged in the performance of Mahaveli Contract is exempt from income tax

16. Tax Incentives to Gem Trade:

Exemption from income tax is available to the gem trade in respect of the following:

1. 24 of 1980 2. 27 of 1982

(a) profits and income arising to any person from sale of gems to the State Gem Corporation. S. 15(a);

(b) profits and income arising to any person from sale of gems after November 15, 1979 at any auction conducted by the Ceylon Chamber of Commerce. S. 15(l).[1] Ceylon Chamber of Commerce means the Ceylon Chamber of Commerce incorporated by the Chamber of Commerce Ordinance. S. 163[1]

(c) the profits and income arising to any person from the export of gems after November 15, 1979; S. 15(m);[1]

(d) profits and income arising to any person authorised by the Central Bank of Ceylon to accept foreign currency from the sale on or after November 15, 1979 from the sale of gems and jewellery, the sale price of which is received in foreign currency. S. 15(o);[1]

(c) Any commission received by a broker who has a licence from the Ceylon Chamber of Commerce on or after November 15, 1979 from the sale of gems at a gem auction held by the Ceylon Chamber or Commerce. S. 15(n).

Any person trading in gems is entitled to exemption of profits from income tax in respect of transactions mentioned above. In the case of a company carrying on any of the above transactions, it will be entitled to exemption from income tax. Any dividends declared and paid by such company in the year in which it received exempt profits or within one year thereafter is exempt from income tax in the hands of the shareholders.

17. Tax Incentive for Investment in the Greater Colombo Economic Commission:

Tax incentives are provided to a company which has entered into an agreement with the Greater Colombo Economic Commission under section 17 of the Greater Colombo Economic Commission Law No. 4 of 1978, on the basis of regulations made under section 17 and 24 of the Greater Colombo Economic Commission law and under the Inland Revenue Act.

A. Tax Concessions provided under the Greater Colombo Economic Commission Law.

The following tax incentives have been announced by the Greater Colombo Economic Commission through the publications of the Commission.

(a) **Tax Holiday:**

A tax holiday up to a maximum of ten years is granted on the following basis:

Number of persons to whom employment is provided in a project	*Minimum eligible tax holiday period*
Upto — 100	2 years
101 — 300	3 years
301 — 500	4 years
over — 501	5 years

1. 24 of 1980

These minimum periods of tax holiday may be extended up to seven vears and in special cases up to a maximum period of ten years depending on the following criteria:

(i) the amount of net foreign exchange earned on export sales.
(ii) the introduction of new technology.
(iii) the magnitude of fixed capital investment.
(iv) substantial exports to new markets.

(b) **Further tax concessions during the tax holiday period:**

Following concessions are also available during the tax holiday period:

(a) there is no liability to income tax on the remuneration payable to foreign personnel employed by the undertaking.
(b) there is no liability to income tax on any royalty payments.
(c) there is no liability to income tax on dividends received by resident or non-resident shareholders.

(c) **Tax concession after the tax holiday period:**

After the end of the tax holiday period the tax liability is restricted to only a Turnover Tax ranging from 2 to 5 percent on the Turnover and will opetate for tax period of fifteen years. The period for which Turnover tax liability only applies is determined on the basis of the tax holiday period allowed by the Commission as is shown below:

Initial Tax holiday period	*Turnover Tax period.*
2	4
3	6
4	9
5	11
6	13
7	15
8	15
9	15
10	15

The rate of turnover tax payable varies between 2 to 5 percent and is determined in each case by the Commission on the following criteria:

(i) the value added in the manufacture of the product.
(ii) the extent of employment generated.
(iii) the magnitude of the initial fixed capital investment.
(iv) the introduction of new technology.

(B) **Tax concessions under the Inland Revenue Act:**

(1) **Exemption of Dividends:**

Any dividends paid by a company with which an agreement has been entered into by the Greater Colombo Economic Commission:–

(i) to any person during the period the company is exempt from income tax or within one year thereafter out of profits which are exempt from income tax;
(ii) to a non-resident person. S. 11(a).

(2) **Capital gains on disposal of shares:**

Capital gains arising on the passing of any shares in a company with which an agreement has been entered into by the Greater Colombo Economic Commission by sale, gift or otherwise is exempt from income tax. S. 14(a)(ix). It must be noted that a disposal of shares in such company the cost of purchase of which has been claimed as a 'qualifying payment' will result in the withdrawal of the tax rebate granted if the shares are disposed within five years of purchase unless the proceeds are invested within three months in the purchase of shares in a company which is an approved undertaking: S. 31 (7).

(3) **Royalty Payments:**

Royalties received by a non-resident person from a company with which an agreement has been entered into by the Greater Colombo Economic Commission during the period in which the company is exempt from income tax under the terms of that agreement is not liable to income tax. S. 15(j).

The liability to tax on royalties paid after the tax holiday period shall not exceed the rate of income tax specified in that agreement as the rate at which income tax is deductible from that royalty. S. 73(5). Such payments are taxed at rates not exceeding 15%.

(4) **Tax liability of a scientist, technician, expert or adviser who is not a citizen.**

There is no liability to income tax on the emolument arising in Sri Lanka, and any income not arising in Sri Lanka of a scientist, technican, expert or adviser who is not a citizen of Sri Lanka and has been brought to and employed in Sri Lanka by any undertaking which is an enterprise with which an agreement has been entered into by the Greater Colombo Economic Commission. S. 9 (c) (iii).

(5) **Investment:**

A company with which an agreement has been entered into by the Greater Colombo Economic Commission is an approved undertaking. S. 31 (a)(b)(ii). Any sum invested by any person in the purchase of ordinary shares, other than the existing shares in such a company is a qualifying payment and qualify for deduction from that person's assessable income in that year of assessment. The amount of the deduction, together with other qualifying payments made by that person is restricted to one third of that person's assessable income for that year of assessment.

18. **Tax Incentives to Foreign Currency Banking Unit:** S. 8(1)(iv)[1]

A foreign currency banking unit means a unit or department of a commercial bank authorised by the Central Bank of Ceylon to operate as a foreign currency banking unit. S. 163.[1]

The profits and income arising to a foreign currency banking unit arising from the following transactions are exempt from income tax.

(a) all off-shore transactions:

1. 24 of 1980

(b) from such on-shore foreign currency transactions of the unit as may be approved by the Minister having regard to the foreign exchange benefits that are likely to accrue to Sri Lanka from such transactions. S. 8 (c) (iv).

On the basis of the guidelines issued by the Ministry of Finance for approval of on-shore foreign currency transactions the following may be approved by the Minister –

(a) on-shore foreign currency transactions entered into with other foreign currency banking units;

(b) on-shore foreign currency transactions entered into with the Greater Colombo Economic Commission;

(c) on-shore foreign currency transactions entered into with residents approved by the Central Bank.

The profits arising from transactions referred to in paragraphs (b) and (c) will be exempt from income tax only up to March 31, 1985.

19. **Tax Incentives for the operation of yachts and pleasure craft by Non-Citizen.** S. 8(e).[1]

Exemption of profits and income of any undertaking for operating Yachts and pleasure craft registered with the Director of Merchant Shipping will apply, if -

(a) such an undertaking is approved by the Minister; and

(b) such an undertaking is carried on

(i) by individuals who are not citizens of Sri Lanka: or

(ii) by a company the shares of which are owned entirely by individuals who are not citizens of Sri Lanka; or

(iii) by Non-Resident Companies.

20. **Tax Incentives for Entrepot Trade**: S. 15.(p)[2]

Profits and income arising from –

(a) Re-export of certain products brought to Sri Lanka on consignment. S. 15(p).[2]

(b) Operation and maintenance of facilities for storage of goods or commodities. S. 15(s).[1]

are exempt from income tax.

(a) **Re-export of certain products brought to Sri Lanka on consignment.** S. 15(p).[2]

Profits and income arising to the consignor or consignee from the export on or after November 15, 1979.

(i) any stones or metals not mined in Sri Lanka;

(ii) any petroleum, gas or petroleum products;[1]

(iii) such other products as may be approved by the Minister having regard to the foreign exchange benefits that are likely to accrue to Sri Lanka from export of such products.

---

1. 40 of 1981. 2. 24 of 1980 and 40 of 1981.

is exempt from income tax, if such stones, metals, petroleum, gas or petroleum products have been brought to Sri Lanka on a consignment basis and re-exported without subjecting such stones, metals gas, petroleum or petroleum products to any process or manufacture[1]

(b) **Operation and maintenance of facilities for storage of goods or commodities**: S. 15(s).[1]

The profits or income arising to any person from an undertaking which has been approved by the Minister for the operation and maintenance of facilites for the storage of goods or commodities brought into Sri Lanka for re-export is exempt from income tax.

21. **Tax Incentives to Resident Individuals, Partnerships and Companies to bring into Sri Lanka profits and income earned abroad**:

Any person who is resident in Sri Lanka is chargeable with income tax on the profits and income wherever arising. S. 2(I) a. In view of this provision all persons who are resident in Sri Lanka and carry on or exercise any trade, business, profession, vocation or employment for however short a period outside Sri Lanka are liable to income tax on such profits and income. Tax incentives are therefore provided to exempt such profits and income provided, such profits and income after deducting reasonable expenses are brought to Sri Lanka. The exemption from income tax will apply only to a resident individual, a resident company and a resident partnership.

(a) **Resident Individuals**:

The exemption applies to emoluments earned in any year of assessment in foreign currency by a resident individual in respect of services rendered by him in that year of assessment outside Sri Lanka;

(a) in the course of any employment carried on or exercised by him; S. 9(1)(k);

(b) in the course of any profession or vocation carried on or exercised by him. S. 15(c).

provided that such emoluments after deducting any reasonable amount expended by such individual as personal expenses are remitted into Sri Lanka. The amount of the personal expenditure deducted must be considered to be reasonable amount of expenditure by the Commissioner General of Inland Revenue.

(b) **Resident Companies and Partnerships.** S. 15 CC.[2]

The exemption from income tax apply to profits and income earned in any year of assessment in foreign currency by a resident company or a partnership which carries on or exercises any –

(a) trade or
(b) business or
(c) profession or
(d) vocation.

in respect of services rendered in that year of assessment. outside Sri Lanka in the course of carrying on, exercising or carrying out:

---

1. 40 of 1981. 2. 27 of 1982

(*a*) a profession; or
(*b*) vocation; or
(*c*) construction project

provided that such profits and income less reasonable expenses are remitted to Sri Lanka.

The amount of expenses deducted must be considered reasonable by the Commissioner General of Inland Revenue.

22. **Tax Incentives for Off-shore Shipping Companies**. S. 8(a) (xxxviii).[1]

An off-shore shipping company is exempt from income tax on the profits and income arising to such a company from a ship which is –

(a) engaged in international operation;
(b) owned or chartered by such company; and
(c) deemed to be a Ceylon Ship by reason of a determination under section 30(c) of the Merchant Shpping Act No. 52 of 1971.

An off-shore shipping company is not entitled to exemption from income tax in respect of profits and income arising to such a company from the carriage by that ship of passengers, mails, livestock and goods to or from any port in Sri Lanka.

In terms of section 30(C) of the Merchant Shipping Act No. 52 of 1971 a ship shall not be deemed to be a Ceylon Ship unless it is owned wholly by a body corporate as may be determined by the Minister.

Exemption of persons employed in off-shore shipping company.

The emoluments earned in any year of assessment by any individual employed on a ship which is owned by an off-shore shipping company and is, deemed to be a Ceylon ship under section 30(c) of the Merchant Shipping Act No. 52 of 1971. S. 9(1)(kk).[1]

Dividends:

Dividends declared by an Off-shore Shipping Company out of the exempt profits and income during the period in which such profits and income are exempt from income tax or within one year thereafter. S. 11(1()(b).[1]

23. **Exemption in respect of certain interest Income**:

Incentive by way of exemption of interest income has been provided to attract capital for use in the Government Development projects and expenditure.The advantage accruing from exemption from income tax must be calcualted by considering the higher return offered for capital in other sectors and the risk factors involved. The exemption of income from interest are provided in respect of the following:

(a) **Interest on Fixed Deposits in the National Savings Bank and on Ceylon Savings Certificates purchased after November 15, 1978.** S. 10(b).

A part of the interest income receivable for an year of assessment by an individual in respect of –

1. 27 of 1982.

(i) National Savings Certificates issued after November 15, 1978, and
(ii) Moneys lying to credit of any individual in the National Savings Bank –

is exempt from income tax.

The part of the interest income that is exempt from income is equal to an amount not exceeding –

(i) Rs. 2,000; or
(ii) one third of the total interest.

WHICHEVER IS GREATER.

The exemption applies to every individual and accordingly any child under eighteen years of age whose income is aggregated with that of his parent is entitled to exemption of such part of the interest as is applicable to him.

(b) **National Savings Certificates** purchased **prior to November 15, 1978.** S. 10(a).

Accumulated interest payable to an individual in respect of Ceylon Savings Certificates or National Savings Certificate purchased by that individual before November 15, 1978 is exempt from income tax.

(c) **Interest income of a company, partnership or a body of persons on certain loans approved by the Minister**. S. 10(c).

Interest income accruing to a company, partnership or other body of persons outside Sri Lanka from any loans granted by them to –

(a) the Government of Sri Lanka;
(b) to any Government institution;
(d) to any other undertaking;

if such loan is approved by the Minister as being essential for the economic progress of Sri Lanka is exempt from income tax.

Rate of Tax on certain Interest not exempt from income tax. S. 32C [1]

The gross interest which is not exempt from income tax payable on a loan granted to any person in Sri Lanka, by any of the following persons out of Sri Lanka being –

(a) a company;
(b) a partnership; or
(c) other body of persons.

is chargeable with income tax at fifteen percent on the interest which arise or is deemed to arise in Sri Lanka.

(d) **Interest on amounts lying to the credit of any person in a Special Account.** S. 10(d).

Interest income accruing to any person from moneys lying to his credit in a Special Account opened by him in a Commercial Bank with the approval of the Central Bank of sums obtained by him by the exchange of foreign currency held by him outside Sri Lanka is exempt from income tax.

1. 27 of 1982.

The exemption is also extended to the income accruing to that person from any investment made by him with the approval of the Central Bank. S. 15(b)

The deposit in the Special Account referred to above or the value of investment made out of such deposit is not liable to wealth tax. S. 45(h).

(e) **Interest on moneys held in foreign currency by any person in any Commercial Bank.** S. 10(e).[1]

Interest income accruing to any person on moneys lying to his credit in foreign currency in any account opened by him or on his behalf in any Commerical Bank is exempt from income tax during –

(a) period in which he is not resident in Sri Lanka; and
(b) for the three years immediately succeeding the date on which he commences to be resident in Sri Lanka.

The basis of determining whether an individual is resident or non-resident has been discussed in Chapter 2. A company or a body of persons is considered resident in Sri Lanka where such a company has its registered or principal office in Sri Lanka or where the control and management of its business are exercised in Sri Lanka. (See Chapter 6 paragraph 9).

The deposit in foreign currency referred to above is also not liable to wealth tax –

(a) during an year of assessment in which he was non-resident; and
(b) any one of the three immediately succeeding years of assessments. S. 45(v).

(f) **Interest on Tax Reserve Certificates.** S. 10(f):

Interest income arising to any person on the surrender of Tax Reserve Certificates is exempt from income tax. Moneys set aside for payment of taxes may be invested in tax reserve certificates which earns interest till tax is due for payment on any specified date. This will provide facility to provide liquid funds for payment of tax, at the same time earning interest, which is tax free.

(g) **Interest on Money held in foreign currency in any foreign currency banking unit.** S. 10(g).[2]

Interest income accruing to any person on moneys lying to his credit in foreign currency with any foreign currency banking unit is exempt from income tax. A foreign currency banking unit is a unit or department of a commercial bank authorised by the Central Bank of Ceylon to operate a foreign currency banking unit. S. 163.[2]

24. Relief from Double Taxation:

Double taxation may arise where a person resident in one country derives profits or income from another country is taxable on the same income both in his own country and in the country from which such profits are derived. In such circumstances governments of countries mutually agree on the basis on which relief against double taxation is to be provided. The Inland Revenue Act provides for such agreement for relief against double taxation in respect

1. 27 of 1982. 2. 24 of 1980.

of income tax, wealth tax or any other taxes of similar character to be concluded between the governments of other countries and where such agreement is approved by the Parliament, will have the force of law.

The double tax agreement provides for -

(a) relief from income tax or wealth tax; or
(b) the basis of charging profits or income arising from sources in Sri Lanka determining the profits or income to be attributed to such persons and their agencies, branches or establishment in Sri Lanka; or
(c) determining the profits or income to be attributed to persons resident in Sri Lanka who have special relationship with persons not so resident. S. 82(1)(a).

The extent of the relief will depend on the basis of the agreement with the respective countries with which such agreement has been entered into by the Sri Lanka Government. The Government of Sri Lanka has in its agreement for providing for double taxation relief generally adopted the principle that Sri Lanka would tax the income arising in or derived from Sri Lanka.

The relief under these agreements are based on the principle of tax credit and or tax exemption. Where credit is given in Sri Lanka in terms of any agreement against the tax payable in Sri Lanka on profits or income arising from sources outside Sri Lanka such credit shall not exceed the amount of Sri Lanka tax payable. S. 82(1)(c).

Double tax agreements are in force between Sri Lanka and the following countries;-

(a) Czechoslovakia;
(b) Denmark;
(c) The Federal Republic of Germany;
(d) India;
(e) Japan;
(f) Malayasia;
(g) Norway;
(h) Pakistan;
(i) Singapore;
(j) Sweden;
(k) United Kingdom.

Relief in respect of Commonwealth Income Tax. S. 83.

Relief from Commonwealth tax paid is available to any person who is resident of a country which does not have any agreement with Sri Lanka for the avoidance of double taxation.

The relief will apply where

(a) any person has paid or is liable to pay both Sri Lanka tax and Commonwealth tax on the same source of income;
(b) that the other country provide a corresponding relief as is granted in Sri Lanka.

The amount of the relief is equal to one half of the Sri Lanka tax or the Commonwealth tax whichever amount is lower; in respect of the income which is subject to taxation in both countries.

Commonwealth tax means any income tax and super tax charged under any law in force in any territory which is a member of the Commonwealth of Nations.

25. Tax Exemption to Resident Guests:

In terms of Resident Guest Tax Exemption Act No. 6 of 1979, a resident guest is entitled to certain tax concessions. The tax concessions applicable to resident guests are:

(a) Exemption from income tax of certain profits and income:

The exemption will apply to –

(i) profits and income of the resident guest which do not arise in Sri Lanka; and

(ii) income accruing to the resident guest from moneys lying to his credit in any account opened by him in a Commercial Bank for the deposit of sums remitted to him in foreign currency from any country outside Sri Lanka;

(b) Exemption from wealth tax in respect of certain property:

Properties which are not liable to wealth tax are:

(i) Movable property of a resident guest which is outside Sri Lanka; and

(ii) Moneys lying to the credit of a resident guest in a Commercial Bank of sums remitted to him in foreign currency from any country outside Sri Lanka including any income accruing to him from such deposists.

(c) Exemption from Estate Duty:

In the event of the death of a resident guest, no estate duty is payable in respect of his estate.

Resident Guest:

A resident Guest is a person to whom residence visa has been granted under the Immigrants and Emigrants Act by the Controller of Immigration and Emigration with the approval of the Minister of Defence, on the Minister being statisfied that such person is:-

(a) a person of eminence in the field of culture or science; or

(b) a person who intends to reside in Sri Lanka during his retirement.

26. Gifts Tax and Estate Duty:

An examination of the Table V and VI in this Chapter will show the extent of the liability of Gifts Tax and Estate Duty. The net income of an individual after taxes and personal expenditure adds on to his wealth. When an individuals wealth, which is his property, is transferred by gift or by inheritance at death, gifts tax and estate duty is imposed.

The rates of Gifts Tax and Estate Duty are similar and since property gifted before death does not form property passing on death, transfer of property may be achieved with minimum of liability to Gifts Tax and Estate Duty. Provisions of Gifts Tax Law under Inland Revenue Act and Estate Duty Act which may be considered when transfer of property is contemplated to the heirs or beneficiaries are given below.

(a) Gifts made during the time of the donor is aggregated to ascertain the gifts tax liability. S. 55(i). Under the Estate Duty Act No. 13 of 1980, S 4. gifts made by an individual does not form part of the property passing on death. Thus subject to taking the exemptions available it may be beneficial to gift part of the property and bequeath the balance of the property to attract Estate Duty liability and thereby benefit by reduction in liability on account of the progressive rate of gifts tax and estate duty.

(b) Where property passing on death includes a residential house a sum of three hundred thousand rupees in value of one such premises is exempt from the payment of estate duty. E.D.A. S. 11. Where such residential house is gifted, the value of the gift will be subject to gifts tax.

(c) Where the last will directs that sum not exceeding one hundred thousand rupees in the aggregate be paid to one or more of any charitable institution is exempt from the payment of estate duty E.D.A. S. 13. A gift after 18th July 1958 up to five hundred thousand rupees during the life time of a donor is exempt from gifts tax. S. 54(d).[1]

(d) Gifts in consideration of the marriage of any child up to a maximum of Rs. 25,000 is exempt from gifts tax. S. 54(1)(c).

(e) A gift by will or in contemplation of death is not liable to gifts tax. S. 54(1)(g) & (h).

(f) A gift of movable property situated outside Sri Lanka of a citizen of Sri Lanka who is not resident in Sri Lanka is not liable to gifts tax. S. 54(1).

(g) Legacies to *bona-fide* employee by last will up to thirty thousand rupees is exempt from Estate Duty; E.D.A. S. 12.

(h) Where the property passing on death includes households goods and jewellery a sum not exceeding Rs. 25,000 is not liable to estate duty. E.D.A. S. 14.

(i) Where the property passing on death of a person consists of the proceeds of a life insurance policy or Tax Reserve Certificate the value of such proceeds are reduced by –

(i) such part of the amount available for payment of estate duty; or

(ii) the amount of the estate duty that would become payable ahd the entirety of such sum formed part of the estate WHICHEVER amount is lower. E.D.A. S. 16.A. S. 16

The payment of life insurance premia is a "qualifying payment" and qualify for deduction from a persons assessable income and secures a reduction of the tax payable. S. 31(2)(h).

The purchase of a life insurance policy provide for a reduction in income tax when alive and for a reduction on the estate duty on the property passing on death.

---

1. 40 of 1981 and 27 of 1982

Chapter 34

WEALTH TAX

Wealth tax is an annual tax imposed on the taxable wealth of the following persons. S. 41.

(a) an individual; both resident and non-resident;
(b) an Executor or Administrator of the estate of a deceased person;
(c) a Hindu Undivided Family;
(d) a Trustee of a Trust;
(e) a Charitable Institution;
(f) a Non-resident Company.

1. Basis of Lability.

The basis of liability to wealth tax is on the market value of the property liable to wealth tax on the first April of the year of assessment or other prescribed basis of valuation. A person holding property liable to wealth tax on the valuation date, that is on the first day of April will incur liability to wealth tax even if he does not own the property during the rest of the year of assessment.

A person resident in Sri Lanka is liable to wealth tax on the value of property wherever situate, other than immovable property outside Sri Lanka.

A Non-resident person is liable to wealth tax on the value of his property in Sri Lanka.

A Non-resident Company owning immovable property in Sri Lanka will be liable to wealth tax; the value on which tax is levied is determined in a specified manner.

2. Wealth

Wealth is defined as movable or immovable property of every kind whatsoever including property required to be included and does not include property required to be excluded. S. 43. Property includes any interest in any movable property. S. 163. The ownership as well as interest in property that exceed six years are brought within the liability to wealth tax. The ownership as well as rights in property constitute wealth of a person.

The law requires that certain property be specifically included while certain property be specifically excluded in arriving at a person's wealth on which tax is chargeable. S. 44 and S. 45.

3. **Property required to be included in a persons wealth. S.** 44(1).

The following properties are required to be included in the wealth of a person:-

(a) **Life interest in any property.** S. 44(1)(a).

When life interest in any property is created, the legal ownership in the property vests in the heir, while the person having the life interest has the right to possess, use and enjoy the benefits from the property during his life time. The liability to wealth tax is on the person having life interest on any property based on the value of property subject to life interest determined as if such life interest did not subsist. S. 49(3). A person having life interest in any property owned by the State is not liable to wealth tax on the value of that property.

(b) **Motor Vehicles.** S. 44(1)(b).

The value of any motor vehicle of which a person is the possessor is included in the wealth of that person. Possessor of a motor vehicle means a a person who is in possession of the motor vehicle in pursuance of any agreement entered into by him in respect of that vehicle. However, if the motor vehicle is in the possession of the taxpayer by reason of any hire purchase agreement, the value of that motor vehicle will not form part of that person's wealth.

(c) **Property subject to a Trust in which there is a sole beneficiary.** S. 44(1)(c).

In the case of property subject to a Trust, where there is only one beneficiary, the value of the property subject to a Trust will be included with the wealth of that beneficiary and will not form part of the wealth of the Trust.

(d) **Property of a trust in which share of the beneficiaries are ascertainable.** S. 44(1)(d).

Where the share of the benefits of the beneficiaries of a Trust is ascertainable from year to year the value of their share of the Trust property as is proportionate to his share of the benefits from the Trust is chargeable on those beneficiaries. The value of chargeable wealth will be proportionate to their share of ascertainable benefits and not on the share of the property.

(e) **Property of a trust where shares of the beneficiaries are not ascertainable.** S. 44(e).

The Trustee of a trust is chargeable with wealth tax on the value of the trust property, where the benefits from the trust to all or any of the beneficiaries cannot be ascertained from year to year.

(f) **The property of a trust of a public character.** S. 44(1)(f).

The trustee of a trust of a public character is chargeable to wealth tax on the property of the trust excluding that property the income from which or the Annual Value of which is exempt from income tax. S. 45(1)(u). The following income of a Trust of a public character is exempt from income tax. S. 8(d):

(i) the net annual value of any place of public worship and its premises administered by such institution;

(ii) the net annual value of the premises owned and occupied by the charitable institution solely for the purpose of that institution;

(iii) the income from any property donated by Royal Grant before 2nd March 1815;

(iv) profits of any business carried on by a charitable institution if such profits are applied solely to a charitable purpose of that institution; and

(a) either the business is carried on in the course of the actual carrying out of the primary purpose of that institution or work in connection is mainly performed by beneficiaries of that institution;[1]

(b) such institution receives grants from the Government of Sri Lanka and approved by the Minister and the business is of a casual nature.

(g) **The property of a partner in a partnership.** S. 44(1)(g)

A partner of a partnership is chargeable with wealth tax on the value of his interest in the partnership.

(h) **The property of the estate of a deceased person administered by an executor.** S. 44(2).

Where the estate of a deceased person is administered by an executor, he is deemed to be a trustee of such estate and every heir to the whole or part of the estate is deemed to be a beneficiary and the estate is deemed to be the property subject to the trust. The liability of the property to wealth tax of a deceased person administered by an executor will be:

(i) the heirs will be chargeable with wealth tax on the value of the property proportionate to their share of ascertainable benefits where the shares of the benefits of the heirs can be ascertained from year to year.

(ii) the executor chargeable with wealth tax on the entire value of the property of the deceased person, where the shares of the benefits of the beneficiaries cannot be ascertained from year to year.

4. **Property required to be excluded from the wealth of a person**

(a) **Immovable property situated outside Sri Lanka.** S. 45(1)(a).

The value of immovable property owned by any person outside Sri Lanka will not form part of the wealth chargeable with wealth tax of that person.

(b) **Movable property outside Sr Lanka of a Non-Resident Person.** S. 45(1)(b).

The value of any movable property situated outside Sri Lanka of a person not resident in Sri Lanka or ceasing to be resident of Sri Lanka in that year of assessment is excluded in making up the wealth of that person. The situation of the property will depend entirely on the basis of the evidence as to where the ownership of the property is legally established.

1. 24 of 1980.

(c) **Interest in the coparcenary property of a Hindu Undivided Family.** S. 45(1)(c).

A person's interest in the coparcenary property of a Hindu Undivided Family is excluded from that persons wealth. A Hindu Undivided Family is a person assessable with wealth tax on its property and thus individual members of such family are therefore notassessable individually on their share of interest of the property.

(d) **Motor Car kept for private use.** S. 45(1)(d).

The value of one motor car kept for private use, of which he is the owner or possessor is excluded from that persons wealth. Where the wealth of a child is aggregated with the wealth of the parent only one car owned either by the parent or the child can be excluded.

(e) **Household effects or other articles of personal use.** S. 45(1)(e).

Household effects or other articles of personal use of which the tax-payer is the owner is excluded from the wealth of that person. Household effects and other articles of personal use which are not exclusively kept for personal use will form part of the wealth of that person i.e. for example such articles kept for purpose of trade or business. Jewellery is not treated as an article of personal use and consequently would be included in the wealth of any person.

(f) **Certain property of a charitable institution.** S. 45(u).

The value of property the income from which or the annual value of which is exempt from income tax will not form part of the wealth of a charitable institution.

(g) **One house used as a residence.** S. 45(1)(f).

The value of one house used as a residence by the taxpayer is excluded from that person's wealth. Where the wealth of a child is aggregated with that of the parent only one house owned either by the parent or the child can be excluded.

(h) **Interest in property not exceeding six years.** S. 45(1)(g).

Value of any interest in any property which does not exceed six years from the date of acquisition of the interest is excluded from a person's wealth. The interest in any property that exceed six years must therefore be inclu-led in a person's wealth. The extent of the liability will be;

(i) *on the person having interest over six years.*

The amount to be included is the value of the interest.

(ii) *The owner of the property.*

the value of the property adjusted in respect of the interest that is attached to that property will be the value that would be included the the wealth of the onwer.

(i) **Deposits or investments made out of money obtained in exchange for foreign currency held abroad.** S. 45(1)(h).

The following are excluded from a persons' wealth:

(i) Deposits of money lying in any Special Account in any Commercial Bank of sums obtained by exchange of Foreign Currency held outside Sri Lanka;

(ii) The value of any investments made with the money's lying to the credit of any Special Account in any Commercial Bank out of sums obtained in exchange for Foreign Currency held outside Sri Lanka.

This exemption will apply provided that, the Special Deposit or Investment is made with the approval of the Central Bank and in accordance with the conditions imposed by the Central Bank.

(j) **Patent, Copyright, Trade Mark, or Registered Design.** S. 45 (i) (i).

A person's right under any Patent, Copyright, Trade Mark or Registered Design not held as part of any business, profession or vocation is excluded from that person's wealth.

(k) **Right or Interest in any life insuarance policy.** S. 45 (1) (j).

Any surrender value of any Life Insurance Policy, before the policy matures, and becomes due for payment is excluded from that person's wealth. Any life Insurance Policy which has matured and has become due for payment to the policy holder should be included in a person's wealth.

(l) **Tools and Instruments necessary to carry on a profession or vocation.** S. 45 (1) (l).

Value of Tools and Instruments up to Rs. 50,000 of a person that are necessary for carrying on a profession or vocation is excluded from that person's wealth.

(m) **Right to receive a pension or Life Annuity.** S. 54 (1) (k).

The value of the right to receive a Pension or a Life Annuity is excluded from a person's wealth.

(n) **Instruments and other apparatus used for scientific research.** S. 45 (1) (m).

The value of any instruments and other apparatus used by a person for the purpose of scientific research are excluded from a person's wealth.

(o) **Work of art, Archaelogical, Scientific or art collection, books or Manuscripts not intended for sale.** S. 45 (1) (n).

The value of these items belonging to a person and 'not intended for sale' are excluded from a person's wealth. These items to qualify for exemption should have been acquired for personal possession and not with intention of selling at a profit at a future date.

(p) **Drawings, Paintings, Photographs and Prints.** S. 45 (1) (o).

The value of these items belonging to a person and is not intended for sale is excluded from the wealth of a person.

(q) **Heirlooms.** S. 45 (1) (p).

Heirlooms are property which pass on to the family members from their parents by custom. However, jewellery is not considered heirlooms for the purposes of exemption and are therefore not excluded from the wealth of a person. Heirlooms belonging to a person for sale do not qualify for exemption.

(r) **Jewellery.** S. 45 (1) (q).

Value of jewellery up to Rs. 50,000 of any person is excluded from the wealth of that person. Where the value of jewellery of a child is aggregated with that of the parent, such parent's total claim for exemption is limited to Rs. 50,000.

(s) **Amounts to a person's credit in any Provident Fund.** S. 45(1) (r).

The amounts of any balance lying to the credit of an employee in any provident fund approved by the Commissioner General is excluded from that person's wealth.

(t) **Foreign currency deposited in any commercial bank by a depositor who is non-resident.** S. 45(1)(v).

The value of any foreign currency deposited in any account with a Commercial Bank in Sri Lanka with the approval of the Central Bank by a non-resident is excluded from the wealth of that person for such year of assessment in which the depositor is a non-resident and any one of the three years of assessment succeeding that year of assessment.

(u) **Property subject to life interest** S. 45(1)(s).

The owner of a property in respect of which life interest subsists on some other person is not liable to wealth tax on the value of the property and is therefore excluded from the wealth of that person.

The person who is having the life interest will be liable to wealth tax on the value of such property. S. 44 (1)s).

(v) **A house completed after October 1, 1966 having a floor area not exceeding five hundred square feet.** S. 45 (1)(t).

A house certified by the Commissioner National Housing as having been completed on or after October 1, 1966 and as having floor area not exceeding five hundred square feet is excluded from the wealth of a person from the year of assessment in which the house was completed or any of the six succeeding years of assessments.

5. **Net Wealth.** S. 47(1).

The net wealth of a person liable to pay wealth tax is the aggregate value of the wealth of that person on the first day of an year of assessment which is in excess of the aggregate value of all the debts owed by him on that day. In computing the net wealth of a person the following debts do not qualify for deduction:

(a) any debt incurred without consideration in money or money's worth.

(b) any debt incurred which is not wholly for his own benefit.

(c) any debt in respect of which there is a right to reimbursement from another person. Where there is no possibility of recovery, such debts can be deducted.

(d) debts charged or secured on or incurred in relation to a property which is not liable to wealth tax. Where the amount obtained by incurring such debt was utilised to purchase, improve or maintain property which is liable to wealth tax qualify for deduction.

(e) any debts incurred outside Sri Lanka. However, where the debts which are:

(i) contracted to be paid in Sri Lanka;

(ii) charged or secured on property in Sri Lanka can be deducted in computing the net wealth of a person.

6. **Taxable Wealth.** S. 48.

Taxable wealth for any year of assessment is that part of the net wealth on which wealth tax is levied. The taxable wealth of persons liable to wealth tax would be as follows:

Individuals. S. 48(1).

The taxable wealth of an individual is the amount of the net wealth as exceeds two hundred thousand rupees.

Trustee, Executor or Hindu Undivided Family. S. 48(1).

The taxable wealth in respect of these persons is that part of the net wealth as exceeds two hundred thousand rupees.

A charitable Institution. S. 48(1).

The taxable wealth of a charitable institution is the amount of the net wealth as exceeds two hundred thousand rupees.

A Non-Resident Company. S. 48 (2).

The taxable wealth of a non-resident company is the product of the multiplication by five of the taxable income attributable to the profits from its immovable property. Income from a unit of accommodation constructed with the approval of the Urban Development Authority comprised in a registered condimonium property is excluded from profits, attributable to immovable property.

7. **Rates of Wealth Tax.**

Rates of wealth tax chargeable on the taxable wealth is as follows:

(a) Persons other than a charitable institution or a non-resident company;

On the first Rs.	200,000 of taxable wealth	$\frac{1}{2}$%
On the next Rs.	500,000 of taxable wealth	$\frac{3}{4}$%
On the next Rs.	1,000,000 of taxable wealth	1%
On the balance taxable wealth	....	2%

(b) Charitable Institution – $\frac{1}{2}$% on all its taxable wealth.

(c) Non-Resident Company – 1% on all its taxable wealth.

8. **Value of property that constitutes wealth.** S. 49.

The value of property for purpose of wealth tax shall be the market value of that property as at first of April in any year of assessment, unless a different basis is prescribed to determine the valuation.

Market value is described as the price which that property would have fetched on that date in an open market. An open market is generally considered as a market in which there is a willing buyer and a willing seller bargaining on equal terms and at arms length, so that the price paid or received reflects a fair and true price for the assets sold.

The value of the property for purpose of wealth tax shall be the market value unless a different basis is prescribed. The basis of valuation have been prescribed in respect of the following:

(a) Immovable property.
(b) Movable property.
(c) Shares in Companies.
(d) Life Interest.

(a) **Immovable Property.** S. 49 (1)[1]

The value of immovable property for any year of assessment shall be its market value on first April of that year of assessment.

Where, any immovable property of a person included in the wealth;

(i) formed part of the wealth of that person on April 01, 1977; or
(ii) was acquired by gifts or inheritance from another person who owned or held an interest in that property on April 01, 1977;

the market value of such property on first April in any year of assessment commencing from April 01, 1977 shall be:

(i) the market value on April 01, 1977 increased by the cost of improvements, additions or alterations made to that property after April 01, 1977;
(ii) the market value on first of April of any year of assessment.

Whichever amount is less.

(b) **Movable Property.**

The value of any movable property, other than cash shall be the market value of that property on first April in an year of assessment. S. 49(2)(a).

(c) **Shares in Companies.**

Shares in companies like any other movable property are valued at the market price. It would generally be, if the shares are quoted in the Colombo Brokers' List, valued at the price quoted therein.

In the case of companies in which:-

(a) the articles of association restricts the right to transfer its shares;
(b) mòre than half the total shares issued are held by not more than five persons, their wives or minor children, either directly or through nominees.
(c) the share have not, at any time during the year of assessment been quoted in the Colombo Brokers' List;

the Commissioner General can direct that the shares be valued by reference to the market value of all the assets of the company as a going concern including goodwill, after deducting:

---

1. 24 of 1980.

(i) par or redemption value, whichever is greater of any debentures, debenture stock and Preference Shares;

(ii) all *bona-fide* debts of the Company;

(iii) any future or contingent liabilities or such liabilities which are uncertain in amount;

(iv) any reserve fund separately invested to be applied solely in payment of pensions to the employees or their dependants or relatives.

(d) **Life Interest**. S. 49(3).

The value of the property which is subject to life interest is determined as if such interest did not subsist. The market value of the property will be liable to wealth tax.

9. **Aggregation of the wealth of the child with that of his parent.** S. 46.

The wealth for any year of assessment of a child of a resident individual is aggregated and deemed to form part of the wealth of:-

(a) his father if the marriage of the parent subsists in that year of assessment; or

(b) the parent who maintains the child and with whom he lives in that year of assessment if the marriage of the parent does not subsist in that year of assessment.

Where the wealth of a child is aggregated with that of his parent, any deductions from wealth to which such child is entitled can be deducted from the wealth of the parent. S. 47(2).

Where the wealth tax cannot be collected from the parent of the child whose wealth has been included with such parent, the portion of wealth tax attributable to the wealth of such child can be collected from such child notwithstanding that no assessment had been made on him. S. 134.

10. **Limit of liability.** S. 50.

The wealth tax payable by any person for any year or assessment shall not exceed 80% of the assessable income of that person for that year of assessment including the amount of income which are exempt from income tax. However, in computing the income for the purpose of calculating the limit the following exempt income is not taken into account:

(i) the net annual value of a residence.

(ii) any subsidy exempt from income tax.

Example:

The profits and income of Mr. Perera for the year ended 31.03.1983 is as follows:

Income from agriculture	Rs.	2,000
Net annual value of his only residence		1,000
Profit on sale of Gem to State Gem Corporation. ...		1,000
	Rs.	4,000

His income from agriculture includes rubber replanting subsidy received during year ended 31.03.1983 amounting to Rs. 1,000.

Mr. Perera's wealth as at 01.04.82

Residential house	Rs.	200,000
Rubber Estate		400,000
Stock of Gems		400,000
Total Wealth	Rs.	1,000,000

Computation of Wealth tax – Year of assessment 1982/83;

	Total wealth		Rs.	1,000,000
Less:	Value of residence			200,000
	Liable wealth			800,000
	Exemption			200,000
	Taxable wealth		Rs.	600,000
	200,000 at ½%	Rs. 1,000		
	400,000 at ¾%	3,000		
	Wealth tax payable ...	Rs. 4,000		
Less:	Relief	2,400		
	Wealth tax payable ...	Rs. 1,600		

Section 50 Relief:

	Total Income		Rs. 4,000
Less:	Net annual value of residence	Rs. 1,000	
	Rubber replanting subsidy	1,000	2,000
			Rs. 2,000
	80% thereof.		Rs. 1,600

Where there is no assessable income, there will be no liability to wealth tax.

11. **Reduction of wealth tax where the total income tax and wealth tax exceeds 80% of the assessable income.** S. 86.

Where the aggregate amount of income tax and wealth tax to which a person is liable exceed the aggregate of the assessable income and income exempt from income tax (other than net annual of one residence and subsidy). such excess shall be set off against the wealth tax to which such person is liable for that year of assessment.

Example II:

The profits and income and wealth of Mr. Perera were as follows:

Year ended 31.03. 1983:

Net profits from rubber estate ...	...	Rs. 15,000
Net Annual value of Residence...	...	1,000
Profits from sale of Gems to State Gem Corporation		1,000

Note: The net profit from rubber Estate include Rs. 1,000 received as rubber replanting subsidy.

Wealth as at 1st April 1982:

Value of rubber estate	...	...	Rs. 700,000
Stock of Gems	...	...	600,000
Cash in hand ...	...	...	600,000

Computation of Liability for the year of assessement 1982/83.

Income Tax:

	Net profits from rubber estate		...	Rs. 15,000
Less:	Rubber replanting subsidy ...		...	1,000
	Adjusted profits from agriculture		...	Rs. 14,000
	Assessable income	...	...	14,000
	Tax free allowance	...	...	12,000
	Taxable income	...	...	Rs 2,000
	Tax payable – 2,000 at $7\frac{1}{2}$%		...	Rs. 150

Wealth Tax:

	Total wealth ...	...	...		Rs. 1,900,000
Less:	statutory deduction	...	...		200,000
					Rs. 1,700,000
	200,000 at $\frac{1}{2}$%	...	...	Rs. 1,000	
	500,000 at $\frac{3}{4}$%	...	...	3,750	
	1,000,000 at 1%	...	...	10,000	
	Wealth tax payable	...	...	Rs. 14,750	

Tax payable after restricting the amount of total wealth tax and income tax to 80% of the Assessable Income:

	Income tax payable	...	...	Rs. 150
	Wealth tax payable	...	Rs. 14,750	
Less:	Relief under S. 50	...	2,900	11,850
	Total of Income and Wealth tax payable			Rs. 12,000

Computation of 80% of Assessable Income:

	Agriculture		Rs. 15,000
	Net Annual Value of residence ...		1,000
	Profits on sale of Gems to State Gem Corporation		1,000
			Rs. 17,000
Less:	Net Annual value of Residence	Rs. 1,000	
	Rubber replanting subsidy	1,000	2,000
	Assessable Income ...		Rs. 15,000
	80% of Assessable Income		Rs. 12,000

Example ii:

Wealth of Mr. Perera and his child Master Perera as at 01.04.1982 were as follows:

Mr. Perera:

Value of Residence	Rs. 88,000
Value of Rubber Estate	200,000
House–hold furniture	25,000
Motor Car 7 Sri Series	75,000
Cash in hand and Bank	4,000
Surrender value of Life Insurance Policy	20,000
Total Wealth ...	Rs. 412,000

He owed the following:

Bank Loan on the security of Life Insurance Policy.	Rs. 15,000
State Mortgage Bank Loan on the security of Estate.	100,000

Master Perera:

House property	Rs. 150,000
Jewellery	75,000
Motor Car 12 Sri series	100,000
Total Wealth ...	Rs. 325,000

Master Perera has no liabilities. He was 16 years of age as at April 01, 1982.

Computation of Wealth tax liability of Mr. Perera and his child for the year of assessment 1982/83:

Mr. Perera:

				Rs.
	Total Wealth		Rs. 412,000	
Less:	House-hold furniture	Rs. 25,000		
	Surrender value of Life Insurance Policy	20,000	45,000	
			367,000	
Less:	Loan on Mortgage		100,000	Rs. 267,000

Master Perera:

	Total Wealth		Rs. 325,000	
Less:	Jewellery ...	Rs. 50,000		
	Value of residence	150,000		
	Motor Car ...	100,000	300,000	25,000
	Total net wealth of the family			Rs. 292,000
	Less: Exemption			200,000
	Total Wealth			Rs. 92,000
	Wealth tax payable at $\frac{1}{2}$%			Rs. 460

Since wealth tax payable does not exceed 80% the Assessable Income no relief is due and the total wealth tax is payable.

Example III:

The wealth of Mr. Silva and his child Miss Silva is as follows: as at 01.04.1982:

Mr. Silva:

Motor Car	Rs. 50,000
Loan on Promissory Note ...	15,000

Miss Silva:

Value of coconut estate	Rs. 200,000
Bank Deposit	50,000
Jewellery	25,000

She has no liabilities. Their assessable income for the year of assessment 1982/83 is Rs. 50,000. Miss Silva was 16 years of age on 01.04.1982.

Computation of Wealth Tax liability for the year of assessment 1982/83 of Mr. Silva as head of the family

Mr. Silva:

	Total wealth	Rs. 50,000	
Less:	Exempted wealth	50,000	
	Wealth liable to wealth tax ...	NIL	
Less:	Loan Liability	15,000	Rs. (15,000)

Miss Silva:

	Value of coconut estate ...	Rs. 200,000	
	Bank deposit	50,000	
	Jewellery	25,000	
	Total wealth	Rs. 275,000	
Less:	Exempted wealth – Jewellery ...	25,000	
	Wealth of Miss Silva		Rs. 250,000
	Aggregate net wealth of the family ...		Rs. 235,000
Less:	Exemption		200,000
	Taxable wealth		Rs. 35,000
	Wealth tax at $\frac{1}{2}$%		Rs. 175

12. Taxable wealth of a charitable institution.

The taxable wealth of a charitable institution is that part of its net wealth as exceeds Rs. 200,000. Where the net wealth of a charitable institution exceeds Rs. 200,000 the entirety of the taxable wealth of such institution is liable to wealth tax at ½%.

Example I:

Net wealth of a charitable institution	Rs.	500,000
Exemption		200,000
Taxable wealth	Rs.	300,000
Wealth tax payable at ½%	Rs.	1,500

13. Taxable wealth of a non-resident Company. S. 48 (2).

A non-resident company having immovable property in Sri Lanka is liable to wealth tax on its taxable wealth at 1%. The taxable wealth of a non-resident company is determined for an year of assessment by multiplying by five the taxable income attributable to the profits and income derived from its immovable property in Sri Lanka. Income from a unit of accommodation constructed with the approval of the Urban Development Authority comprised in a registered condimonium property is excluded from profits attributable to immovable property.[1]

Example:–

XYZ Ltd., a non-resident company having an undertaking for the manufacturing of goods derived income from the manufacturing business and income from renting its warehouse. The assessable income of the company the year of assessment 1982/83.

Profits from manufacturing	Rs.	1,000.000
Rent from warehouse		100.000

Computation of wealth tax liability:

Taxable wealth	100,000 × 5	= 500,000
Wealth tax payable at 1%		= 5,000

The wealth tax liability is thus equal to 5% of the taxable income attributable to the immovable property owned by the non-resident company.

14. Double tax relief on wealth tax paid in another country. S. 84(1).

Relief from double taxation is available to a resident of Sri Lanka who is liable to wealth tax in respect of his wealth in Sri Lanka and in another country for the corresponding year of assessment where there is no arrangement for the grant of relief from double taxation. S. 84(1). A resident of Sri Lanka is liable only on movable property situated outside Sri Lanka and therefore the relief will apply to Wealth Tax payable on the value of movable property.

The amount of the relief is the amount of the wealth tax payable in respect of such property in Sri Lanka and in another country whichever is less. The wealth tax payable in respect of property which is subject to double

---

1. 27 of 1982.

taxation is an amount equal to the proportion of wealth tax applicable to such property to the value of his total wealth. That is:—

$$\frac{\text{Taxable Wealth subject to double taxation}}{\text{Value of total taxable Wealth}} \times \text{Wealth tax on total taxable wealth} = \text{Wealth tax attributable to wealth subject to double taxation.}$$

Chapter 35

GIFTS TAX

Gift is a disposition of property made otherwise than by will without consideration in money or money's worth, passing from the donor to the donee. A tax on gifts was introduced as from 18th July, 1958, as a complementary tax to Estate Duty, which was in operation since 1919.

1. **Meaning of Gift.**

Gift means a "transfer by one person to another of any existing movable or immovable property made voluntarily and without consideration in money or money's worth, and includes the transfer of any property deemed to be gift". S. 52. The scope of the meaning is enlarged by deeming certain transactions, which cannot come within the definition of gift, as gifts chargeable with tax. S. 53.

2. **The charge of Gift Tax.**

The liability to gifts tax is on every individual and on every Company on the taxable gifts made in any year of assessment, The taxable gifts made by the members of the family are not aggregated for the purpose of computing the gifts tax liability. Certain persons are specifically exempted from gifts tax liability. S. 54.

There is no liability to gifts tax on persons other than individuals and Companies i.e. bodies of persons, clubs, trusts etc.

3. **Liability to Gifts Tax.** S. 58.

The liability to gifts tax is on the donor, but the donee is liable to gifts tax if:–

(*a*) the donor dies without leaving any property in Sri Lanka or the property he leaves in Sri Lanka on death is not sufficient for the recovery of gifts tax; or

(*b*) the donor ceased to be a resident of Sri Lanka, leaving no property or the property he has in Sri Lanka is not sufficient to recover gifts tax; or

(*c*) the circumstances indicate that it is not practicable to make an assessment on the donor.

Where an assessment is made on the donee, the liability of the donee is restricted to the amount of the gifts tax which would have been payable by the donor for the year of assessment in which the gift was made which is attributable to the value of the gift to the donee.

The donor is any person who makes the gift. The donee is a person who acquired any property under a gift and where a gift is made to a trustee for the benefit of another person, includes both the trustee and the beneficiary. S. 169.

4. **Recovery of Gifts tax.** S.137.

The donor is liable to pay the gifts tax on taxable gifts made by him. Where the gifts tax cannot be recovered from the donor, it may be recovered from the donee although no assessment has been made on him. The amount of the gifts tax that can be recovered, in such circumstances, shall not exceed the gift tax attributable to the value of gift made to the donee as at the date of the gift.

5. **Apportionment of tax between donees.**

Where the tax cannot be recovered (S. 137) or where the liability to gifts tax is on the donee in certain circumstances (S. 58) the amount of the gifts tax payable by the donee is limited to the proportion of the gifts tax applicable to the value of gifts made to the donee.

Example:–

Mr. Perera made the following cash gifts to his two daughters on 01.10.1982.

Miss Manel Perera	Rs. 40,000
Miss Maureen Perera	Rs. 40,000

Mr. Perera died on December 15, 1982, and there were no assets left at death and it is therefore not possible to recover the gifts tax due from him. The gifts tax due will therefore be apportioned between the two children and will be recovered from them in the following manner.

Gifts made	Rs. 80,000
Tax payable is as follows:	
First Rs. 50,000	NIL
Balance Rs. 30,000 at 5%	1,500

Tax payable by each child is apportioned as follows:

Miss Manel Perera: $\frac{40,000}{80,000} \times 1,500 = 750$

Miss Maureen Perera: $\frac{40,000}{80,000} \times 1,500 = 750$

6. **The scope of gifts tax liability.**

A gift is defined as a transfer by one person to another of any existing movable or immovable property made voluntarily and without consideration in money or money's worth, and include transfer of any property deemed to be gift. S. 52. The essential elements of a gift are:

(*a*) there must be transfer of property;,

(*b*) the transfer is by one person, the donor to another person, the donee;

(*c*) the transfer must be of existing movable or immovable property;

(*d*) transfer must be made voluntarily;

(*e*) transfer must be made without consideration in money or money's worth.

7. **Transfer of Property.**

The definition of gift covers any property' which would mean all kinds of property. Property is defined to include any interest in movable or immovable property. S. 163. The word property can mean all that a person could call his own in law, both tangible and intangible, movable and immovable. It is every possible interest which a person can have in law.

Transfer of absolute ownership of both movable and immovable property including interest in such movable or immovable property without consideration attracts liability to gifts tax. The interest transferred must exist in the movable or immovable property. The interest can be legal, or equitable, present or vested or contingent, original or substitutive interest. The interest can be vested either in the capacity of a mortgagor or mortgagee, lessor or lessee, tenant for life or remainderman.

Transfer of property is defined as any disposition, conveyance, assignment, settlement, delivery, payment or other alienation of property including creation of a trust in property and the grant or creation of an interest in property. S. 163.

Trust is an obligation annexed to ownership of property and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner: (S. 30 Trust Ordinance). When a trust is created the ownership of the property and all the beneficial interest passes from the donor as individual to the donor as trustee, and such transfer will attract gift tax liability.

Transfer must be complete, in that in the case of immovable property the transfer must be registered and in the case of movable property the property must be delivered. In the case of negotiable instruments like cheques, the cheque must be cashed. Where a gift can be revoked, the gift must be complete as to attract gifts tax liability.

The definition of gift does not indicate that the gift must be accepted, but in certain circumstances the acceptance may be necessary to attach liability.

8. **Transfer by one person to another.**

The transfer must be in favour of another person, for no man can make a gift to himself. In cases where any property is jointly vested with another person, liability will arise when the other person makes an appropriation out of that property. S. 53(c). Where the vesting is for the benefit of the donor, there will be no liability. The identity of the donor and the donee must be distinct to attach liability.

9. **Property must exist at the time of Gift.**

A gift of future property is mere promise and such gift is not complete and is imperfect. An interest in property is an existing property. An actionable claim to property is an existing property.

10. **Must be made voluntarily.**

The donor must gift the property of his own free will without any duress or undue influence brought to bear on the donor. Where a gift is made in these circumstances, the donee cannot retain the benefit even though he is innocent. Where any imperfect gift is not challenged by the donor or by the donee and the gift is given effect to such gift will attract gifts tax liability.

11. **Without consideration in money or money's worth.**

The definition although imply that the gift must be without consideration, it does not mean complete absence of consideration, for in the case of transfer for inadequate consideration the excess of the market value over the value of the consideration is deemed to be gift. S. 53(b).

The gift arising out of the binding promise before hand to make the gift will be liable provided there is an element of bounty. Where the disposition is made under a sense of moral obligation is a gift for the motive for making the gift does not affect the liability. The absence of any legal obligation and an element of bounty will distinguish gifts from other dispositions.

12. **Transactions which are deemed to be gift.** S. 53.

(a) **Transfers of property for a consideration which is less than the market value of that property.** S. 53(a).

Where the property is transferred for a consideration which is less than the market value of that property on that date, the excess of the market value over the value of the consideration for transfer will be deemed to be a gift made by the transferor. The transferor will in the first instance be required to give his reasons why the value of the consideration is less than the market value of that property before an assessor proceeds to make the assessment. For example where a property with a market value of Rs. 50,000 has been transferred for Rs. 25,000 the excess fo the consideration Rs. 25,000 will be deemed to be a gift passing from the transferor to the transferee

(b) **Where the consideration for transfer has not passed or is not intended to pass either in full or in part.** S. 53(b)

Where a formal deed of transfer has been made out and no consideration has passed or is intended to pass such a transfer will be deemed to be a gift. Where part of the consideration has passed and the balance is not intended to pass, the consideration which has not passed will be deemed to be gift. The assessor will require the transferor before treating the consideration which did not pass as gift to satisfy him that the consideration has in fact passed to the transferee.

Example

(i) Mr. Perera transfers a property worth Rs. 20,000 to Mr. Silva and receives no payment thereof nor it is intended to receive any payment for the transfer. The entire value of the property Rs. 20,000 will be deemed to be a gift.

(ii) Mr. Perera transfers a property for Rs. 10,000 while its market value is Rs. 25,000 to Mr. Silva and receives no payment at all. In this instance the whole of the consideration at its market value will be deemed to be a gift.

(iii) Mr. Perera transfers a property for Rs. 25,000 and receives Rs. 10,000 and does not intend to claim the balance. Mr. Perera will be deemed to have made a gift to the value of Rs. 15,000.

(c) **Vesting of property jointly with himself and any other person without adequate consideration and the other person makes appropriation out of this property.** S. 53(c).

Where a person absolutely entitled to any property vests any property in him and any other person jointly without adequate consideration and the other person makes an appropriation out of that property the owner is deemed to have made a gift of that property to another person as at the date of appropriation. Where the appropriation has been made for the benefit of the absolute owner no gift will be deemed to have been made. An appropriation by the other person for the benefit of any other person will also be deemed to be a gift by the absolute owner of the property which was jointly vested.

Example of the arrangement can be seen clearly for example in the operation of a joint account out of which appropriation are made for the benefit of either parties. The vesting can be in any manner and need not be in any particular form, and require no written document. Where the appropriation is partly for the benefit of the owner and partly for the benefit of the other person, then only the portion applicable to the other person will be deemed to be a gift.

Distinction must be made with regard to a joint account of a husband and wife by mutual arrangement. Appropriation made for meeting household expenses may not constitute gift. Acquisition of any property for the benefit of either of the spouses will attract gifts tax liability.

(d) **The release, discharge, surrender, abandonment of any debt, contract or other actionable claims.** S. 53(d).

The value of the release, discharge, surrender or abandonment of a debt or contract is the amount on which gifts tax is chargeable. In the case of a trade debt, the debt which is treated as bad debt in computing the profits of a business will not constitute a gift. Debts which are abandoned without consideration will be deemed to be gifts.

A contract is an agreement enforceable in law and the abandoning of any rights under the contracts will constitute gift unless such abandonment is made bonafide on considerations of commercial expediency.

A person abandoning any interest in any property for which he is legally entitled to will be deemed to have made a gift.

(e) **Gifts subject to reservation in favour of the donor or any other person.** S. 53 (e).

Where a gift is made subject to the reservation of any benefit or any other advantage in favour of the donor or any other person, the gift is deemed to be made at the time when the instrument creating the reservation is made and not when the reservation is extinguished–for example where a parent gifts his house to his child with the reservation of the life interest. In such an event the child will have equitable interest in the property while the donor will have the beneficial interest in the property. A gift of such a nature is deemed to take a place at the time of the transfer and not when the life interest is extinguished.

The full value of the gift without any deduction in respect of the reservation will be value of the gift liable to gifts tax in the hands of the donor. S. 56(3).

13. **Gifts which are not liable to gifts tax.**

(a) **Immovable Property situated outside Sri Lanka.** S. 54 (1)(a)

There is no liability to gifts tax on the gift of any immovable property situated outside Sri Lanka.

(b) **Movable property outside Sri Lanka.** S. 54 (1)(b).

Gift of movable property outside Sri Lanka is exempt unless such an individual is a citizen of Sri Lanka and is resident in Sri Lanka during the year of assessment in which such gift is made. An individual who is not a citizen of Sri Lanka or is not resident in Sri Lanka during the year in which the gift was made, will not be liable to gifts tax. A citizen of Sri Lanka who is resident in Sri Lanka in the year of assessment will be liable to gifts tax on the gifts of movable property outside Sri Lanka.

(c) **Gifts in consideration of marriage up to Rs. 25,000**. S. 54 (1) (c).

Gifts in consideration of marriage of any child whether such child is over or under 18 years of age, of an individual up to Rs. 25,000 is not liable to gifts tax. The exemption will apply for both husband and wife if they made gifts individually of their own to their child.

The intention of the person making the gift may not be relevant in considering whether a gift was made in consideration of marriage. A gift is in consideration of marriage, according to Lord Radcliff in the case of *IRC v. Lord Rennel* 1963 1 AER 803.

"......... a gift made in consideration of marriage is a transfer made on the occasion of marriage, contingently on the marriage taking place, and containing such limitation, if made by the way of settlement, as amount to the customary provision for the spouses and the issues of the marriage."

In the same case Lord Cohen laid down three requisites for a gift to be made in consideration of marriage:

(i) it must be made on the occasion of marriage;

(ii) it must be conditional only to take effect on the marriage taking place;

(iii) it must be made by a person with the purpose of or with a view to encouraging or facilitating the marriage.

In the case of *Attorney General v. O. M. De Livera*, 3 CTC 474, Estate Duty Case where the respondent contracted love marriage and got father's blessing before marriage. The father made an oral promise to gift certain property and gifted same some seven years later. In his last will he devised the same property to the respondent with the stipulation that she should pay Estate Duty on it. It was held that this gift was not made in consideration of marriage, in that it failed to satisfy the necessary requisite of having been made on the occasion of marriage, and of being conditioned to take effect on its taking place and of having made to encourage or facilitate it.

In *Kandapa v. Charles Appu* – 27 NLR 433 (1966) it was decided that under the Kandyan Law a dowry could be given before or at the time of marriage or even after marriage, if it was in pursuance of a promise made before marriage.

Under the Thesavalamai Law, in the case of *Subramania v. Murugesu*, 69 NLR 532 (1967) it was held that a dowry could be given before marriage. Thesavalamai Law applied to Tamil inhabitants of the Northern Province under which certain property is deemed to be owned commonly by both spouses. In these circumstances both spouses can claim the deduction of Rs. 25,000 from gifts made in consideration of marriage, where a gift has been made by both of them jointly.

(d) **Gifts made by an individual to an Approved Charity or any Institute, foundation, or Commission.** S. 54(1)(d).[3]

A gift which is over Rs. 1,000 in value and subject to a maximum of Rs. 500,000 in value for the life time of an individual made on or after July 18, 1958 exempt from gifts tax where such gift has been made to:–

(a) an approved charity;
(b) the Ceylon Institute of Scientific and Industrial Research;[1]
(c) the Sri Lanka Foundation;[1]
(d) the Tower Hall Theatre Foundation;[1]
(e) the Sri Lanka Invnstors Commission;[1]
(f) the S. W. R. D. Bandaranaike National Memorial Foundation;[2]
(g) the Institute of Fundamental Studies;[3]
(h) the International Winged Bean (Dambala) Institute;[3]

An approved charity means any public charitable trust or institution declared by the Minister of Finance as an approved charity and published in the Gazette: S. 31 (9) (a).

(e) **Gifts made to the Government or to any Local authority.** S. 54 (e).

Gifts made to:–

(a) the Government;
(b) any local authority;
(c) any Higher Educational Institution established under Universities Act No, 16 of 1976.[3]

are not liable to Gifts tax. No limit to the value of gifts has been made in respect of gifts to these bodies.

(f) **Exemption from Gifts tax in respect of certain gifts by Companies.**

Gifts made by any company to:–

(a) the Government;
(b) local authority;
(c) an approved charity.

is not liable to gifts tax. S. 54 (2).

(g) **Gifts not exceeding Rs. 2,000 made in an year.** S. 54(1)(g).

Where the aggregate value of the total gifts made by an individual in a year does not exceed Rs. 2,000 there will be no liability to gifts tax for that year of assessment. Where the gift made exceed Rs. 2,000 the entire gift is liable to gifts tax.

1. 24 of 1980. 2. 40 of 1981. 3. 27 of 1982.

(h) **Gifts made by will.** S. 54 (1) (h)

There is no transfer of property by will and consequently there will be no liability to gifts tax. Properties which are devised by will pass on the death of the testator and will be liable to Estate duty at that time.

(i) **Gifts made in contemplation of death**. S. 54 (1)(i).

Gifts made in contemplation of death are not liable to gifts tax. Such gifts will from part of the dutiable estate and will be liable to estate duty.

A property is deemed to be gifted by any individual in contemplation of death in the following circumstances: S. 54 (3).

(i) where the gift is made by an individual who is ill and expecting to die of his illness gives possession of any property which is to be a gift to that person in the event of his death; and

(ii) that the gift is revocable by the donor and is inoperative in the event of the donor's recovery from his illness or the donor surviving the person to whom the gift was made by him in contemplation of death.

14. **Taxable Gifts.** S. 55 (1).

Taxable gifts of an individual or a comapny for an year of assessment is the total value of all gifts made during the year of assessment after deducting the value of all exempt gifts. The value of taxable gifts made by members of the family will not be aggregated and each individual member of the family is liable to pay the gifts tax due on the gifts made by them.

16. **Computation of Gifts Tax.** S. 55 (2).

Since Gifts Tax operates as a complimentary tax to Estate Duty, the rate schedule for gifts tax applies progressively to all taxable gifts made by the same donor over his life time irrespective of the year of assessment in which the gifts is made.

In order to arrive at the gifts tax payable for an year of assessment, the gifts tax payable on the aggregate value of all taxable gifts made between 18th July, 1958 to the end of the year of assessment is calculated at first by applying the rates applicable to the year of assessment. S. 55(2)(a). From the tax so arrived at, the aggregate amount of the gifts tax paid for any previous year of assessment is deducted. S. 55(2)(b). The resultant amount is the gifts tax payable for the particular year of assessment.

16. **Deduction of any stamp duty paid on gifts.**

Where stamp duty has been paid in respect of any instrument by which an individual has made a taxable gift, the amount of such stamp duty can be deducted in arriving at the gifts tax payable for any year of assessment. Where the stamp duty exceeds the gifts tax payable the excess stamp duty paid over the gifts tax cannot be claimed. S. 57.

Example: I:

Mr. and Mrs. Perera made the following gifts to her daughter Manel as dowry on the occasion of her marraige on 30th June 1975.

Mr. Perera:

House Property	Rs.	100,000
Cash		50,000
He paid stamp duty on the gift deed amounting to	Rs.	1,600

Mrs. Perera:

Cash	Rs.	50,000
Jewellery		50,000
House-hold effects		20,000

On 30th June 1982 Mr. Perera made a cash gift to his daughter Shanti at the time of her marriage Rs. 150,000.

Computation of Gifts tax liability:

Mr. Perera – Year of assessment 1976/77:

House Property	Rs.	100,000
Cash		50,000
		150,000
Less: Exemption of gift in consideration of marriage:		10,000
Taxable gifts.	Rs.	140,000

50,000 at 3%	Rs	1,500
25,000 at 10%		2,500
25,000 at 12%		3,000
40,000 at 15%		6,000
Gross gifts tax	Rs.	13,000
Less: Stamp duty Paid		1,600
Gifts tax payable	Rs.	11,400

Mrs. Perera – Year of assessment 1976/77:

Cash	Rs.	50,000
Jewellery		50,000
House-hold effects:		20,000
		120,000
Less: Exemption – in consideration of marriage:		10,000
Taxable gifts ...	Rs.	110,000

50,000 at 3%	Rs.	[illegible]00
25,000 at 10%		2,500
25,000 at 12%		3,000
10,000 at 15%		1,500
Gifts tax payable. ...	Rs.	8,500

Mr. Perera — Year of assessment 1982/83:

Gift during the year	Rs.	150,000
Less: Exemption in consideration of marriage		25,000
Taxable gift for the year ...		125,000
Taxable gifts of previous years ...		140,000
	Rs.	265,000

50,000	NIL
100,000 at 5%	5,000
100,000 at 10%	10,000
15,000 at 15%	2,250
Gross gifts tax payable	17,250
Gifts tax charged up to 1978/79 ...	13,000
Gifts tax payable. ... ... Rs.	4,250

17. **Determination of the value of Gifts.** S. 56.

The value of property, other than cash and immovable property acquired by the donor prior to April 01, 1977 which constitute gift, is the market value of that property on that date on which gifts was made. S. 56 (1). Market value of any property means the price which, in the opinion of an Assessor, that property would have fetched on that date in an open market, S. 163. An open market is a market in which there is a willing buyer and a willing seller bargaining on equal terms and at arms length so as to reflect the fair and true price for the property.

(a) **Value of property subject to reservation.**

Any gifts of property which is subject to any reservation in favour of the donor or any other person is valued as if the gift passed without any reservation. S. 56 (3). When a gift is made subject to reservation the property is deemed to be made at the time when the instrument creating the reservation tion is made and not when the reservation is extinguished. The full value of the gift without any adjustment is chargeable with gifts tax.

(b) **Shares in Companies.** S. 56 (2).

Shares in companies like any other movable property is valued at the market value on the date of the gift, based on the quotations on the Colombo Brokers List.

In the case of companies in which:

(a) by its articles restricts the right to transfer its shares;
(b) more than half the total shares issued are held by not more than five persons either directly or through nominees;
(c) the shares have not, within the period of twelve months immediately preceeding the date of gifts was not quoted in the Colombo Brokers List:

The Commissioner General can direct that the shares be valued by reference to the market value of all the assets of the Company as a going concern including goodwill, on the date of which gift was made. S. 49 (2)(b)

When shares are valued on this basis the following deductions can be claimed:

(i) par or redemption value whichever is greater of any debentures debenture stock and Preference shares;

(ii) all debts of the company incurred or created bona fide for consideration in money or money's worth;

(iii) all future or contingent liabilities or such liabilities which are uncertain in amount;

(iv) any reserve fund separately invested to be applied solely in payment of pensions to the employees or their dependants or relatives.

(c) **Value of gift of immovable property acquired by the donor prior to April 01, 1977.** S. 56 (1A).[1]

The value for purpose of gifts tax in respect of immovable property acquired by the donor prior to April 01, 1977 is:–

(a) Market value of such property as at April 01, 1977 increased by an amount equal to the cost of improvement, additions or alterations made on or after April 01, 1977;

(b) the market value of that property on first April in the year in which the gifts is made.

Whichever value is less.

18. **Gifts Tax and Estate Duty.**

The gifts tax rate schedule is identical with the rate schedule applicable to Estate Duty. The gifts made by any individual during his life time does not from part of the dutiable estate on his death and the liability to Estate Duty will extend only to property left at death. The incidence of Gifts Tax and Estate Duty may be reduced by gifting part of the property during the life time and leaving part to be subject to estate duty liability on death and benefit by a reduction in gifts tax and estate duty, on transfer of property to heirs or beneficiaries, in the progressive rate structure. In such circumstances consideration must be given to exemptions from gifts tax and estate duty in respect of certain properties.

19. **Gifts made by a Company.**

A Company is liable to pay gifts tax in respect of any taxable gifts made during an year of assessment.

The gifts tax payable by a company for any year of assessment shall be calculated at fifty per centum on the value of all taxable gifts. S. 55(4).

Gifts made by a Company to:–

(a) the Government;

(b) Local authority;

(c) an approved charity.

s not liable to gifts tax. S. 54(2).

20. **Rates schedule of Gifts Tax.**

Rates of gifts tax applicable for gifts made on or before 01.04.1979.

1. 24 of 1980.

(a) **Individuals:**

On the first	Rs.	50,000	of taxable gifts	NIL
On the next	Rs.	100,000		5%
	Rs.	100,000		10%
	Rs.	100,000		15%
,, ,,	Rs.	100,000	,, ,,	20%
,, ,,	Rs.	100,000	,, ,,	25%
,, ,,	Rs.	200,000	,, ,,	30%
,, ,,	Rs.	200,000	,, ,,	35%
,, ,,	Rs.	200,000	,, ,,	40%
,, ,,	Rs.	200,000	,, ,,	45%
,, ,,	Rs.	200,000	,,	50%
,, ,,	Rs.	500,000	,, ,,	55%
,, ,,	Rs.	500,000	,, ,,	60%
On the balance of taxable gifts.				70%

(b) **For Companies:**

On the value of all taxable gifts.	50%

Chapter 36

PROPOSED CHANGES IN INLAND REVENUE ACT

This chapter examines the effect of the changes proposed by the Minister of Finance in his Budget Proposals as affecting the taxation of income as contained in the Inland Revenue Act No. 28 of 1979 as amended by Inland Revenue Amendment Acts No. 24 of 1980, 40 of 1981 and 27 of 1982. These observations should not be treated as a statement of the principles and practice as the precise legislation giving effect to these changes have not been enacted.

The changes announced briefly are:

(1) Tax Incentives to Exports. S. 20.

(2) Withdrawal of relief for investment in shares in approved companies which qualify for 100% deduction from assessable income: Section 31 (2) (m) and 31 (6).

(3) Incentive for the construction of houses: S. 31 (2) (b).

The proposed changes will apply as from April 01, 1983.

1. **Tax Incentive for Exports:**

The final date for approval for tax holiday for undertaking of companies which are engaged solely in the manufacture and export of any commodities in is now extended beyond March 31, 1983. The exemption from income tax will apply for a period of five years from the date on which the company made its first exports. The conditions for approval of tax holiday under the earlier provisions as explained in chapter 33 paragraph 12 are likely to remain unaffected.

2. **Investment in shares in approved Companies which qualify for 100% deduction:**

The section 31(5) and 31(6) is likely to be amended thereby withdrawing the 100% investment relief on the investment in ordinary shares of approved Companies with a Capital of over Rs. 500 million undertaking the following projects:

(a) Tourist Hotel Undertakings. S. 16 A.

(b) Property Development Projects. S. 22 B.

(c) Non-traditional Large Scale Agricultural undertakings. S. 22 D.

These companies which have received "approved undertaking" status will continue to have that status for a period of five years from the date of first issue of shares.

Any investment in shares of a subsequent issue of new shares after April 01, 1983 will qualify for deduction together with any other qualifying payment up to one third of a person's assessable income.

Any person who made an investment in ordinary shares which qualify for 100% deduction before March 31, 1983, which exceeds his assessable income, may be able to carry forward the excess for set off against the assessable income of the succeeding years of assessments

Example:

The assessable income of Mr X for year ended 31.03.1983 is Rs. 100,000. He purchased shares in an approved company which qualify for 100% deduction for Rs. 200,000. before 31.03.1983.

Computation of Liability – Year of Assessment 1982/83:

	Assessable Income	Rs. 100,000
Less:	Qualifying Payment	200,000
	Taxable Income	NIL

Amount carried forward for set off for year of Assessment 1983/84 Rs. 100,000

A person may be able to plan his tax providing for a deduction this way for subsequent years if he is satisfied the investment will yield him the best returns on an investment appraisal study.

3. **Deduction of the Cost of Construction of a house to be spread for fifteen years:**

Any amount spent by an individual in the construction of a house out of his own financial resources and not out of loans from approved lending institution will now qualify for deduction spread over a period of fifteen years. The amount of the deduction including any other qualifying payments each year is restricted to one third of the assessable income of an individual.

Hitherto the cost of construction was allowed to be spread over a five year period. It will now be possible to claim investment relief on the cost of construction of a house spread over a period of fifteen years.

The earlier provisions permitted the spreading of the cost of purchase of the first house or the first site for the construction of a house purchased after April 01, 1978 out of an individuals own financial resources and not out of loans from approved lending institutions for five years of assessments for purpose of investment relief as qualifying payment. It is expected that the facility to spread the cost of purchase for a period of fifteen years may be extended to cover cost of purchase of a house or a building block.

4. **Tax Incidence:**

The withdrawal of the deductibility of:

(a) the cost of plant, machinery and fixtures after 01.04.81 and

(b) the 100% investment in shares in certain approved companies is likely to increase the tax bill in the year of assessment 1983/84 and subsequent years of assessments.

Deductions permitted from assessable income when the law is amended will be:

(a) a deduction of Rs. 12,000 as tax free allowance; and

(b) a deduction up to one third of the assessable income for years of assessment 1983/84 and subsequent years.

The tax incidence of an individual on the assumption that he invests up to a maximum of one third of his assessable income will be as follows:

Assessable income Rs.	*Maximum deductions Rs.*	*Taxable Income Rs.*	*Income Tax Rs.*	*Income after Tax Rs.*	*Effective Rate of Tax %*
50,000	28,666	21,334	3,053	46,947	6.1
100,000	45,333	54,667	16,626	83,374	16.6
200,000	78,666	121,334	53,293	146,707	26.6
300,000	112,000	188,000	89,960	210,040	29.9
400,000	145,333	254,667	126,626	273,374	31.6
500,000	178,666	321,334	163,293	336,707	32.6
1,000,000	345,333	654,667	346,626	653,374	34.6

Where no investments are made tax liability will be higher than shown above.

5. Mitigating the incidence of tax:

Although it is not possible to deal with all avenues of mitigating the incidence of tax following major areas may be considered in the short run:

(a) Substantial investment in the purchase of omnibuses for passenger transport. The cost of omnibuses qualify for 75% depreciation allowance up to March 31, 1983 and carry forward losses may be utilised for future years:

(b) Substantial investment in excess of the estimated assessable income for year ended March 31, 1983 in shares in companies which qualify for 100% investment relief may be made before March 31, 1983 and utilise the carry forward of the excess investment to reduce tax liability in subsequent years; S. 31(b).

(c) Undertaking new ventures in,

(*a*) agriculture;
(*b*) horticulture;
(*c*) animal husbandry:
(*d*) inland fisheries projects;
(*e*) poultry farming;
(*f*) rearing of livestock

may be undertaken in the year of assessment commencing April 01, 1983. The law provides for the deduction of certain capital expenditure in the commencement of these projects and in the first few years tax losses may be available for set off against other sources of income.

6 Procedural amendements to Inland Revenue Act:

Certain procedural amendments are also made to the Inland Revenue Act giving effect to the proposed changes. The precise legistation will be known only when the law is enacted and must be taken into account in considering the observations on the new Budget proposals.

INDEX

CAPITAL GAINS:

CLUBS:

CHARITABLE INSTITUTIONS:

COOPERATIVE SOCIETIES:

DEDUCTION OF TAX AT SOURCE:

DIVIDENUS:

EMPLOYMENT:

EXECUTOR:

GIFTS TAX:

HUSBAND, WIFE AND CHILD:

INCOME FROM PROPERTY:

INCOME FROM INTEREST:

LOSSES:

NON-RESIDENT INDIVIDUALS:

NON-RESIDENT PERSONS — LIABILITY: OF