LIST OF INTERPRETATIONS

(In a generalized and summarized form)

Set III

Committee for Interpretation of Tax Laws
Department of Inland Revenue
November 2015

Message from the Commissioner General

The publication of this book is the result of painstaking and dedicated efforts of the Interpretation Committee. First of all I wish to express my sincere gratitude and appreciation to the Chairman and members of the Interpretation Committee for their hard work and commitment in compiling this most important publication.

Taxation is the key means for securing macroeconomic stability and growth. Hence, the Inland Revenue Department has a huge responsibility to ensure the sufficient flow of funds to the General Treasury of the country by the collection of tax revenue through enhanced voluntary compliance. This book provides clarification and guidance regarding ambiguous and complex tax issues to officers of this Department as well as tax advisors and tax payers. I am sure this will be of great assistance in dealing with upcoming taxation and related issues.

Kalyani Dahanayake
Commissioner General of Inland Revenue
November 20, 2015

November 11, 2015

Interpretation of Tax Laws – Set III

This is **Set III** of the List of Interpretations issued by the Department of Inland Revenue under the Committee appointed by the Commissioner General of Inland Revenue. Interpretations **Set I** and **Set II** were issued in November 2013 and November 2014 respectively which consists of Interpretations issued up to the relevant periods.

As stipulated in Section 208A of the Inland Revenue Act, No. 10 of 2006, [which was introduced by the Inland Revenue (Amendment) Act, No. 22 of 2011] , the Committee (comprising senior officials) is statutory empowered for the interpretation of provisions of any enactment administrated by the Department of Inland Revenue, notwithstanding anything to the contrary in such enactments. In addition, the Committee is required in terms of such mandate, to issue all necessary guidelines and instructions to ensure uniformity in the application of such provisions in line with such interpretation.

As it is considered necessary, the Revenue Officers, Tax payers as well as the Tax Practitioners need to be apprised of the interpretations given by the Committee with respect to provisions of the revenue enactments. Therefore, such interpretations which could be summarized in such a manner, that the secrecy with regard to the affairs of the respective taxpayers is preserved, are given in a generalized form entailing the respective **interpretation number** and the **section** of the relevant enactment.

Certain clarifications given by the Secretariat on specific issues based on the facts of the case, explaining the departmental viewpoint on respective issues, and to ensure consistency in the application of the law, are also incorporated with the reference number of the connected source file.

Apart from that, explanatory notes on amendments made to the relevant Acts have also been issued parallel to the Interpretations and clarifications given in this document.

D. G. P. W. Gunatilaka
Deputy Commissioner General (Tax Policy)
Chairperson – Committee for Interpretation of Tax Laws

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Interpretations under

(A). INLAND REVENUE ACT, NO. 10 OF 2006

[hereinafter referred to as "IR Act"]

01. Whether the "overtime allowances" paid to Doctors and Nurses of the Government Hospital could be treated as exempt from income tax?

"Overtime allowances" form part of the employment income as specified in section 4 of the IR Act. However, certain allowances paid to Government employees are exempt from income tax as special payment made to any employee for emergency or priority services or for any special task rendered or carried out by such employee, stipulated in section 8 (1) (u) of the IR Act [such services have been specified in item 4 of the Circular - on instructions to employees in the Government sector on taxation of the employment income and tax deductions under PAYE Scheme- (SEC/2014/06)]. Since the "Overtime allowance" is not considered as a special payment for such emergency or priority services, such allowance is liable to income tax.

However, if the overtime allowance is not made on regular basis, PAYE Tax Table 2 may be applied to calculate the income tax chargeable.

[IC/2013/96] **[Section 4]**

02. Whether the profit and income derived by a company for providing transport services through a train rented out from the Department of Railway and providing other services such as food, accommodation, bookings for sightseeing and transport services in addition to the train service through a package, to foreign tourists for the payment in foreign currency could be treated as exempt under section 13 (ddd) of the IR Act?

As per section 13 (ddd) of the IR Act, No. 10 of 2006 as introduced by the Act, No. 9 of 2008 and amended by the Act, No. 22 of 2011,

'the profits and income earned in foreign currency by any resident company, any resident individual or any partnership in Sri Lanka, from any service rendered in or outside Sri Lanka ***to any person or partnership outside Sri Lanka****, other than any commission, discount or similar receipt for any such service rendered in Sri Lanka, if such profits and income (less such amount, if any, expended outside Sri Lanka as is considered by the Commissioner-General to be reasonable expenses) are remitted to Sri Lanka through a bank," is exempt from income tax.*

Therefore, for the application of exemption under Section 13 (ddd), service could be rendered in or outside Sri Lanka but the recipient of services should actually and completely be out of Sri Lanka.

Accordingly, rendering service to a foreign person visited Sri Lanka could not be treated as *a service rendered to any person or partnership* ***outside Sri Lanka*** even though the company is earned in foreign currency. Hence the exemption is not applicable.

[IC/2015/16] **[Section 13 (ddd)]**

03. Clarification on the liability to Income tax of a recruitment agency which provides employment in foreign countries.

The recruitment agent in Sri Lanka is an agent of the foreign principal who carries on the activities as set out below on behalf of the principal for which the fees are remitted in foreign currency.

- Advertising in local newspapers for recruitment of required personnel and interviewing and selection of them.

- Attending the required formalities and documentation of the Sri Lanka Foreign Employment Bureau (SLBFE) and the Immigration Department.

- Booking the air flight and making flight arrangements and attending to relevant formalities.

- Ensuring the handover of prospective employees to the representatives of foreign principals at the airports of destination.

The above activities are the routine work that any recruitment agent would carry out in the business of a recruitment agency and such activities cannot be considered as work carried out on behalf of the foreign principal. Certain activities can be considered as activities carried out on behalf of the employees as well.

In terms of section 13(o) of the IR Act, No. 10 of 2006, such part of any sum as does not exceed three thousand rupees paid by the Sri Lanka Bureau of Foreign Employment, established by the Sri Lanka Bureau of Foreign Employment Act, No. 21 of 1985, to any person or partnership licensed by such Bureau, to carry on the business of a foreign employment agency, in respect of any Sri Lankan for whom employment outside Sri Lanka has been

provided or secured by such person or partnership , is exempt from income tax. Accordingly, the liability to income tax would be on any profit in excess of such amount.

The liability to income tax on the fee or commission received for the services provided to the person outside Sri Lanka would depend on the facts of the case. If it is a commission the liability arises.

[IC/2013/29] **[Section 13(o)]**

04. (i) Whether the new company formed with an additional investment up to the level of investment required for the new undertaking referred to in section 17A, by purchasing plant and machinery from a company in the same group which is to be liquidated consequent to the transfer of the assets to the new company, could be treated as "new undertaking" for the purpose of income tax exemption under section 17A of the IR Act, No. 10 of 2006?

(ii) Whether the date of commencement of commercial operations to determine the commencement date of exemption period, could be the date in which the full investment is completed in case where the company has already in the commercial operation due to the phased commissioning of production plants has already been commenced?

(i) As stipulated in subsection (2) of section 17A, the term "**new undertaking**" means, any undertaking which engages in any activity specified in paragraph (a) of that subsection with the required investment referred to in that subsection in the

acquisition of fixed assets after March 31, 2011 but prior to April 1, 2015, which commences commercial operations on or after April 1, 2011, but prior to April 1, 2016; and which is not **formed by the splitting up or reconstruction or acquisition of any business which was previously in existence.**

The investment is defined as the cost of any land, plant, machinery, equipment and other fixed assets.

Accordingly, the eligibility of the exemption is subject to the fulfillment of the conditions specified in that section.

A new company formed by transferring the assets of another company consequent to the closure of the operations of that company could not be treated as a "new undertaking" even though the required investment is made, as it is only a shifting of an existing business to a new location. However, the additional investment made could be considered as an expenditure (investment) of an expansion project subject to the fulfillment of conditions specified therein.

(ii) In terms of subsection (1) of section 17A, the exemption from income tax of a company from **any new undertaking,** reckoned from the commencement of the year of assessment in which such undertaking **commences to make profits from transactions entered into in that year of assessment** or from the commencement of the year of assessment immediately succeeding the year of assessment in which such undertaking completes a period of two years reckoned from the date on which such undertaking commences to carry on commercial operations, whichever occurs earlier:

Accordingly, exemption has to be reckoned from the date in which the undertaking fulfills the conditions specified in

subsection (1) of section 17A, even though the company has not been completed the full investment (since the company plans to make the full investment in several phases) as yet if company has not fulfilled minimum investment criteria and other requirements within stipulated period specified under section 17A, the tax exemption will be limited to the applicable time frame for that investment. The subsequent investment after the commencement of the tax holiday could not be qualified to extend the tax holiday period.

If the required investment has not been made before commences to make profits from transactions entered into in that year of assessment the exemption is not applicable**.**

However, the subsequent investment may fall within the provisions of expansion project for which qualifying payments if the condition for expansion project is fulfilled.

[IC/2014/47] **[Section 17A]**

05. Whether the capital allowance is claimable by the provider (Finance Company) on vehicles sold under Hire Purchase Agreement entered into in terms of the Consumer Credit Act, No. 29 of 1982, since the ownership is not passed to the hirer until the completion of the payments and as per the Certificate of Registration of Motor Vehicles issued by the Department of Motor Vehicles the absolute owner of the said vehicles is the finance company?

The provider of financial facility under Hire Purchase Agreement entered into in terms of the Consumer Credit Act, No. 29 of 1982

is not entitled for the claim of depreciation allowance on assets supplied under such agreements. Due to the following reasons:

i. **Depreciation Allowances on acquisition of an asset:** There is no specific provision in the IR Act in which hire purchase agreements are dealt with. Hence, the applicable provisions are section 25 and section 26 of the IR Act subject to the fulfillment of the provisions therein.

Section 25(1) (a) specifies the conditions under which the allowance is granted and the ensuring paragraphs list out the categories of qualifying assets and rates thereon. The said section provides the following:

" subject to the provisions of subsection (2) and (4) , there shall be deducted for the purpose of ascertaining profits and income of any person from any source, all outgoings and expenses incurred by such person in the production thereof including:

(a) an allowance for depreciation by wear and tear of the following assets ***acquired*** *constructed or assembled and arising out of* ***their use*** *by such person in any trade, business , profession or vocation carried on by him"*

Accordingly, the entitlement for depreciation allowance is on the condition that the asset is **acquired** and **used** in trade, business, profession or vocation**.**

The word "acquired" is defined in section 217 of the IR Act to mean that "*acquired by purchase, gift, inheritance or exchange or any other manner……*" The use of words "purchase" "gift" and "inheritance" have the result of transferring legal ownership to the acquirer or beneficiary. Hire Purchase is a system of acquiring goods on credit

(installment credit) whereby the seller is regarded as the dealer, the purchaser is regarded as the hirer and the financier is the owner. The owner is only providing financial facility to the purchaser for the acquisition of the asset. The source of income of the financier is interest (finance charges). Hence, finance company has not used the asset. Therefore, the condition for the claim of depreciation allowance has not been fulfilled.

The general provision of section 25(1) (a) of the IR Act limits the claim of depreciation allowance to the owner of the asset. Even though the hirer/ purchaser obtain ownership only upon the completion of the agreed payment under hire purchase agreement, the intent of the hire purchase agreement is to acquire the Title in the goods by means of credit financing from the financier. Thus, the provisions of section 25(1) (a) apply to the purchaser of the assets as he seeks to acquire ownership of the assets.

ii. Hire purchase agreements and leasing agreements are two different scenarios applied in financial arrangements. Under leasing, the lessor is entitled to claim the depreciation allowance due to the simple reason that the total lease rental is taken as income for income tax purposes. Hence, finance company is treated as the user of the asset. Accordingly, lessee is not entitled to claim depreciation allowance on the same rationale. Further, for the purposes of VAT, the total lease rental is treated as supply and the input credit is allowed on the purchase of the asset by the finance company.

However, under Hire Purchase Agreement, the total installment is not treated as income. It is a finance charge (interest). Hence, the Finance company is not treated as the user of the asset but only a facilitator of the credit

arrangement. As such, the asset is not used by the finance company, as it is subject to sale. Ownership of financer said to be only for the purpose of security (coupled together with right of repossessing) for settlement made to seller and credit is allowed to purchaser. Accordingly, it does not fulfill the condition of section 25(1) (a).

The asset is effectively used in the business of the hirer/ purchaser. Hence, the depreciation allowance is an entitlement of the purchaser subject to fulfillment of the conditions specified therein.

Similarly, for VAT purposes, the purchase consideration is split into two elements. Namely, the cash price for which VAT is charged by the finance company and collected from the purchaser and the financial charges are not subject to VAT but subject to VAT on financial services.

In view of the above facts, capital allowance is not available for the provider of financial facility.

[IC/2013/93] **[Section 25(1) (a)]**

06. What would be the tax treatment for returnable containers / cylinders etc. consequential to the adoption of Sri Lanka Accounting Standards (LKAS) which consist of Sri Lanka Financial Reporting Standards (SLFRS)?

The application of the provisions of the IR Act consequential to the adoption of Sri Lanka Accounting Standards (LKAS) which consist of Sri Lanka Financial Reporting Standards will be as follows.

- Paragraph 6 of LKAS 16 defines property, plant and equipment (PPE) as tangible items that are used in the production or supply of goods and services for rental to others, or for administrative purposes and are expected to be **used during more than one period**.

- Paragraph 6 of LKAS 2 defines inventories as assets held for sale in the ordinary course of business, in the process of production for such sale or in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Accordingly, returnable containers fall under the definition of property, plant and equipment, if such containers are used for the supply of goods and are expected to be **used for more than one period.**

Such containers would qualify under the definition of inventories only if the containers are held for sale in the ordinary course of business. Since **returnable containers** are not held for sale they cannot be categorized as inventories.

The Accounting Standard adopted for inventories is LKAS 2 and item 02 of the Regulations in complying with the respective provisions of the IR Act, as gazetted under Gazette No 1857/8 on April 09, 2014, adjustments/information required to be adopted made or provided, for tax purposes are as follows:

i. Any inventory (e.g. returnable packaging materials) re-classified in line with Sri Lanka Accounting Standards (LKAS) as non-current asset shall continue to be treated as inventory in line with the existing tax practice.

ii. When inventories are purchased with deferred settlement terms, the finance cost element shall not be separated from

> the purchase figure for tax purpose. The whole invoice value shall be considered for tax purposes while the imputed interest element, if any, charged to statement of income is disallowed.

Therefore, For the purpose of taxation, the adjustment referred to in item 2.1 of the SLFRS Gazette No 1857/8 of April 9, 2014 stated above is applicable and as expressed therein returnable packing material etc. as re-classified as non-current asset shall continue to be treated as inventories in line with the existing tax practice **whereas, returnable containers such as bottles etc. which could be used for more than one period is treated as PPE.**

Enterprises may have applied different accounting treatments prior to the SLFRS implementation. Some may have treated returnable containers as PPE and claimed depreciation, whereas, the others may have treated returnable containers as stock and claimed replacement cost as expenditure. Following the adoption of IFRS, the tax treatment should be unique. Accordingly, as per the new rules, returnable containers which are expected to be used for more than one year should be treated as PPE.

Accordingly, the Enterprises that have claimed replacement cost by taking the returnable containers as inventories prior to the adoption of IFRS need not be reversed with regard to the transaction that have already taken place, however for any future transactions the PPE basis is to be adopted.

The same basis may be applied for gas cylinders as well. However, in the case of gas cylinders the tax treatment needs to take into consideration the treatment applied by the company on the cylinder deposits. Some Enterprises write back deposits automatically to Profit & loss A/c as per the agreement with the

customer by considering usage of the cylinder i.e. if container is returned in year 1 the company will refund 100%, whilst in the 2nd year refund will be for only 75%, 3rd year 50% etc. hence such write back amount needs to be considered as profit for tax purposes.

However, returnable packing materials etc. which are expected to be used for less than one year will be treated as inventory as per the above Gazette No 1857/8.

[IC/2014/26] **[Section 25(1) (a)]**

07. Clarification on the specification of Research and Development (R&D) expenditure incurred by the software developer for the enhancement of existing software products.

The provisions relating to the deductibility of expenditure on R&D was expanded by allowing double deduction in the year 2011 and triple deduction in 2012. The relevant provisions as provided in paragraph (i) of subsection (1) of section 25 of the IR Act, are as follows:

"(i) for any year of assessment –

(i) *commencing prior to April 1, 2011, the expenditure including capital expenditure; or*

(ii) *commencing on or after April 1, 2011, an amount equal to two hundred per centum of the expenditure, including capital expenditure,*

incurred by such person in carrying ***on any scientific, industrial, agricultural or any other research*** *for the*

upgrading of any trade or business carried on by such person:

Provided that-

(A) where such expenditure is incurred on or after April 1, 2012 but prior to April 1, 2013 and such research is carried out through ***any Government institution****;*

(B) where such expenditure is incurred on or after April 1, 2013 and such research is carried out through ***any institution*** *in Sri Lanka,*

the deduction shall be an amount equal ***to three hundred per centum*** *of such expenditure incurred by such person.".*

As defined for the purposes of that paragraph,

*"****scientific, industrial, agricultural or any other research"*** *means any such research which is carried out for product or produce innovation, or improving the quality or character of any product, produce or service but does not include any market research or feasibility studies.*

The entitlement for the deduction, therefore, is subject to the fulfillment of the requirements specified in that paragraph of the IR Act.

The IT related research falls under "**any other research**" in the definition and should be for product or produce innovation, or improving the quality or character of any product, produce or service. The Development of software with new features etc. is a normal activity and software developed by a software developer is a new product depending on the requirement of the client. Such

activities, therefore, could not be considered as R&D for the purpose of tax deduction under section 25 of the IR Act.

However, the under mentioned activities could be treated as R&D which would qualify **only** for **double deduction if it is incurred by yourself.**

- any systematic investigation or search that is carried out in a field of science or technology by means of experiment or analysis including experimental development, namely, work undertaken for the purpose of achieving technological advancement for the purpose of creating new or improving existing materials, devices, products, processes or services, including incremental improvements thereto,

- applied research, work undertaken for the advancement of scientific knowledge with a specific practical application in view,

- research work undertaken with the object of acquiring new knowledge with potential application in view,.

In the software development sector, the final result of the above process has to be a new innovation qualified as R&D. In order to prove such R&D expenditure the patent right of the new application may be evidence which could be considered for eligibility for deduction subject to the facts that the result of the research should be identifiable.

It should also be noted that:

- As per the present provisions, the triple deduction is available only if the research is carried out by Government or private research institution and in other circumstances; If the company itself incurs such expenditure the deduction is

restricted to twice the expenditure incurred.((w.e.f April 1, 2015 , triple deduction is entitled to the company too only if such R&D expenditure incurred for new innovation)

- Part of the profits earned may be exempted under section13 (ddd) of the IR Act if the conditions specified therein are fulfilled. The deduction of the expenditure on R&D also should be in the same manner.

[IC/2013/41] **[Section25 (1) (i)]**

08. Whether the royalty expense which was accrued but income tax (WHT) deducted and paid on such amount could be allowed as a deduction under section 32 of the IR Act?

Deductibility of ground rent or royalty whether paid to a person outside Sri Lanka or otherwise is deductible in the following manner:

- Prior to April 1. 2014 , royalty or ground rent paid is deductible from the total Statutory income subject to the conditions specified therein under section 32 of the IR Act.

- On or after April 1, 2014, ground rent or royalty is deductible in ascertainment of the business profits if incurred in the production of income under section 25 of the IR Act , subject to the condition such royalty or ground rent is payable for such year of assessment and paid also during such period. As such no deduction is allowable on such payments under section 32.

- However, with regard to royalty or ground rent payable prior to April 1, 2014 but paid subsequently on which deduction

is not permitted under section 25 (due to the reason it should be for the relevant period) such payment is still permitted under section 32.

As stipulated in paragraph (b) of subsection (1) of section 95 of the Inland Revenue Act, No. 10 of 2006, deduction is permitted only if the Withholding tax (WHT) has been deducted.

In this case on the payment to be made to a person outside Sri Lanka WHT has been deducted in the year of assessment 2010/2011 whereas the payment has been made in the year of assessment 2011/2012.

Therefore, even though the income tax on royalty had been deducted (WHT) in the year of assessment 2010/2011, the deduction under section 32 could be allowed for the year of assessment 2011/2012 in which the Royalty payment had been made.

[IC/2013/109] **[Sections 32]**

09. Whether the payment made to Presidential Secretariat by a Public Corporation, (which anyway should transfer the profit to the Consolidated Fund), to be used for organizing an international event approved by the Cabinet of Ministers, could be treated as a qualifying payment considering it as a donation to the Government specified under sub section 2 of section 34 of the IR Act, No. 10 of 2006?

As per the proviso to sub-section 2 of section 34 of the IR Act, if any public corporation is required in terms of the law by or under which such corporation is established to remit any profits of such corporation to the **President's Fund** which is established by the

President's Fund Act, No.7 of 1978, such remittance made by such corporation to such fund is deemed to be a donation made to the government, and therefore it will be a qualifying payment.

However, payment made to Presidential Secretariat would not fall under that category. Any payment made out **of the contribution which has any way to make the Consolidated Fund** is an advance payment requested out of the contribution to the Consolidated Fund considering the urgent requirement of government spending.

Specifying the purpose for which it was used is not a reason to treat the payment as a government donation, (out of the contribution anyway to be made to the Consolidated Fund), could not be treated as a donation made to the Government for the purpose of claiming qualifying payment.

[IC/2014/49] **[Section 34(2)]**

10. Whether the cost incurred for the purchase of an old machine from an associate company could be deductible as qualifying payment under Section 34 (2) (s) of the IR Act?

As per the provisions laid down in sections 16C and 17A of the IR Act, the profits and income of any new undertakings subject to the fulfillment of conditions therein shall be exempt from income tax for a period specified therein.

With regard to existing companies qualifying payment relief under section 34(2) (s) is applicable subject to the same conditions referred to in section 16C or Section 17A.

One of the conditions specified for new undertaking referred to in section 16C or 17A is that the new undertaking is not formed by **splitting up or reconstruction or acquisition of any business which was previously in existence.**

Apart from that there should be an expansion project which may be similar to a new undertaking for which the exemption would have been considered. Mere investment on fixed assets would not be qualified for deduction for qualifying payment unless there is an expansion project.

Even an expansion is proved still the condition specified for a new undertaking referred to in section 16C or section 17A, that the new undertaking is not formed by a **splitting up or reconstruction or acquisition of any business which was previously in existence has not been fulfilled** is applied to the expansion project as well.

As the asset has been purchased from an associated company which resulted in shifting of one sector of that company to other company, the company is not qualified for deduction under section 34(2)(s) .

[IC/2014/35] **[Section 34(2) (s)]**

11. Whether the compensation received for loss of office based on the settlement of a Court case filed by the tax payer could be considered as the compensation received for loss of any office or employment on uniform basis for the application of concessionary rate of tax on the terminal benefits from employment? Could the expenditure incurred on the Court case i.e. legal fees be deducted from the compensation received?

(i) In terms of:

- paragraph (o) of subsection (1) of section 8 of the IR Act, No. 10 of 2006, the exemption, up to Rs. 2Mn (paid as compensation for loss of office), is applicable only if such payment is made under a voluntary retirement scheme uniformly applicable to all the employees by the employer or of the retrenchment of an employee by the employer in accordance with a scheme approved by the Commissioner of Labour.
- subsection (2) of section 35 of the said IR Act, the terminal benefits from employment including compensation for loss of office is taxed at the rates specified in Part IV of the First Schedule, if such payment is made under a uniformly applicable Scheme to all the employees. In a case where the compensation is made under a scheme which is not uniform to all the employees, the applicable rate is referred to in Part V of the First Schedule.

(ii) In terms of paragraph (b) of sub-section (1) of section 26 of the IR Act, no expenses incurred other than the unpaid salary and contributions made by employers to provident fund, pension fund or savings fund approved by the Commissioner General for the purpose of section 217 can be deducted.

Accordingly, payment made as legal fees is not deductible from the income from employment.

The compensation received for loss of office based on the settlement of a Court case filed by the tax payer could not be treated as from a scheme uniformly applicable to all the employees.

As such, the applicable rate is 20% (a maximum of) prior to 01.04.2013 and 16% (a maximum of) on or after 01.04.2013.

Further, the expenditure incurred i.e. legal fees on the above Court case is not deductible as explained above.

[IC/2013/101 & IC/2013/108][Sections 8(1)(o), 26 (1)(b) and 35(2)]

12. whether the concessionary rate of 10% of income tax applicable to undertakings referred to in section 59B of the IR Act, No. 10 of 2006 as amended by the IR (Amendment) Act, No. 22 of 2011, could be applied on the income derived by a lawyer, by providing professional service through a chamber?

Section 59B of the aforesaid IR Act states that:

1. *The profits and income of any person (not being the holding company, a subsidiary company, or an associate company of a group of companies) for any year of assessment commencing on or after April 1, 2011, from any undertaking referred to in subsection (2) shall, notwithstanding anything to the contrary in any other provisions of this Act, but subject to provisions of section 59F be chargeable with income tax at the appropriate rate specified in the Fifth Schedule to this Act-*

2. *For the purpose of this section "undertaking" in relation to any year of assessment means any undertaking-*

   (a). engaged in the manufacture of any article or in the provision of any service; and

   (b). the turnover of such undertaking (other than from the sale of any capital asset) for that year of assessment-

      (i) being any year of assessment commencing on or after April 1, 2011 but prior to April 1, 2013, does not exceed three hundred million rupees;

      (ii) being any year of assessment commencing on or after April 1, 2013, does not exceed five hundred million rupees.

Providing professional services by maintaining an office to provide such services could be considered as an undertaking for the purpose of section 59B of the aforesaid IR Act.

Hence, the profits and income derived by a lawyer, by providing professional service while maintaining a chamber to provide such services is chargeable to income tax at the concessionary rate of 10% for any year of assessment commencing prior to April 1, 2014 and 12% for any year of assessment commencing on or after April 1, 2014 as specified in item 33 of the Fifth Schedule to the IR Act, No. 10 of 2006 as amended by the IR(Amendment) Act, No. 8 of 2014 on satisfying the other conditions specified therein.

[IC/2014/43] **[Section 59B]**

13. Whether the deduction of income tax from reward payments made by any government institution for investigations conducted in the capacity of an employee of such institution could be made by treating such rewards as profits from employment under section 4 of the IR Act or under section 157 of the IR Act considering such payments as a reward to informants?

As per section 4 of the IR Act, No. 10 of 2006,

"Profits from any employment ***include****—*

(a) (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 his employment;"***

Accordingly, any payment receives by any "employee" in the course of his employment should be included as profits from his employment.

Section 157 of the IR Act states that,

"Notwithstanding anything to the contrary ***in any other law****, where,*

(a). any Government institution pays a reward or distributes a share of fine other than any such share of fine paid out of the Consolidated Fund or which will fall under the profits from employment in terms of section 4 of this Act, in relation to any individual who holds any paid office under the Republic of Sri Lanka, to any person;

(b). ……"

As specified in this section, there is no ambiguity that the above provision is applicable to an individual **other than an employee of that institution**, since any payment which is received being of an employee of that institution falls under the profits from employment as stated in section 4 of the aforesaid IR Act. It should be noted that section 157 supersedes only "**any other law**" but not the provisions of the IR Act, which specifically removed the application of that provision with regard to employees.

Accordingly, the provisions of section 157 are meant to collect income tax from individuals who receive rewards by participation in the process not being employees but being persons providing information etc., hence not applicable to employees.

Therefore, PAYE tables as specified in section 116 of the IR Act should be applied on rewards paid by the Department institution to its employees by treating such payment as profit from employment under section 4 of the IR Act, No. 10 of 2006.

[IC/2015/17] **[Sections 4 and 157]**

14. Could the dividend tax payable out of the dividends already distributed were set off against Economic Service Charge (ESC) payments since the tax on dividend distributed forms part of the liability of the tax payable by a company under section 61 of the IR Act?

Even though the tax on dividend forms part of the liability of the tax payable by a company under section 61 of the IR Act, such tax on dividends is payable by the holder of dividends and the company required to pay such tax on behalf of him.

Therefore, In terms of section 65 of the IR Act, Withholding Tax (WHT) is deducted from the dividends distributed to shareholders

and the remitting of tax so deducted to the Commissioner General is a responsibility of the company.

Accordingly, WHT so deducted on the dividends distributed (unless such dividends are exempt under section 10), should be paid on or before the thirtieth day succeeding the date of distribution of such dividends in terms of subsection (3) of section 113 of the IR Act. As such, the set off against ESC does not arise.

[IC/2014/59] **[Sections 61, 65, and 113(3)]**

15. Clarification on ascertaining the liability to WHT on the royalty payments made to a person outside Sri Lanka on which tax is borne by the payer.

In terms of section 95 of the IR Act, when a royalty payment is to be made to a person outside Sri Lanka, withholding tax is to be deducted at the rate specified in the Double Taxation Avoidance (DTR) Agreement where there is such agreement entered into between Sri Lanka and that other country in which the recipient of royalty is resident. If there is no such agreement the tax is to be deducted at the rate of 20% as specified in the Fourth Schedule.

Depending on the agreement or agreement entered into between the payer and recipient, tax could be borne by the payer. If the tax is borne by the payer in Sri Lanka, the tax liability has to be calculated by treating the royalty payable as the net payment and the tax is calculated as follows:

Royalty payment /90 * 10 and Royalty payment /100 * 10

Since the tax is borne by the payer, the total payment made to the person outside Sri Lanka is equal to the net amount, which is 90%

of the total payment. Accordingly, the total expenditure of the payer is equal to gross amount of the royalty and not the net amount.

[IC/2014/57] **[Section 95]**

16. Whether the income derived from mining and selling of raw gems, mining and selling of polished gems through Auction of Gem and Jewellery Authority and other sales made by any person could be exempted from income tax?

In terms of section 161A (1) of the IR Act, No. 10 of 2006 as amended by the IR (Amendment) Act, No. 9 of 2008;

"The National Gem and Jewellery Authority established by the National Gem and Jewellery Authority Act, No. 50 of 1993, shall deduct from the sale price of any gem sold at any auction conducted by it, income tax of an amount equal to 2.5 per centum of the sale price of such gem from the sum payable to the seller of such gem and at the time such sum is paid to the seller"

Accordingly, income tax at the rate equal to 2.5% is deductible on the sale price of such gem sales made through an auction by the National Gem and Jewellery Authority at the time such sum is paid to the seller.

Further, as specified in section 32(3) (h) of the aforesaid IR Act, profits and income from the sale of any gem on which the above mentioned 2.5% tax has been deducted shall not be included to the assessable income of such person.

Apart from that exemption is provided in section 13 of the IR Act on the profit and income of the following:

(i) the profits and income within the meaning of paragraph (*a*) of section 3 arising to any person from the export of gold, gems or jewellery [section 13(i)]

(ii) such part of the profits and income arising from the sale for payment in foreign currency, of any gem or jewellery, being a sale made in Sri Lanka by any person authorized by the Central Bank of Sri Lanka to accept payment for such sale in foreign currency [section 13(j)] .

Therefore such person is liable to pay income tax only on the income which the income tax of 2.5% which stated above has not been deducted or exempt subject to the fulfillment of the conditions as specified in section 13 of the IR Act stated above .

As well, any profit on sale of gems at any other auctions other than the auction carried out by the Gems and Jewellery Authority is also liable for income tax as mentioned above.

[IC/2015/25] [Sections 13(i), 13(j), 32(3)(h) & 161A(1)]

17. Which date should be considered as the date of approval of shareholders' to execute the share buyback to be ascertained the dividend since there is no provision in the Companies Act which mandates shareholder approval to execute a buyback of shares in the case of a listed company?

As per the amendment introduced to the definition of "dividend" by sub - paragraph (v) to paragraph (a) of that definition, share buyback is treated as a dividend up to the extent of the payment made for such share buyback over the market price quoted in the Colombo Stock Exchange or the market value of such share as the

case may be, as at the date on which the shareholders of such company at a meeting approved such share buyback.

There is no provision in the Companies Act which mandates shareholder's approval to execute a buyback of shares in the case of a listed company. It is only in the case of a private company that shareholder approval is a prerequisite in terms of the Companies Act.

Accordingly, in line with the Companies Act, No. 7 of 2007, in a case of a listed company, the date of approval of the share buyback is the date of the Board Resolution and the market value of shares for the calculation of dividend is the value quoted in the Colombo Stock Exchange, subject to the condition that the transaction is taken place in accordance with the time line stipulated by the Colombo Stock Exchange.

Accordingly, the difference between the offer price to buy back the shares and the market value of shares on the date of Board Resolution shall be considered as dividends under the definition of "dividend" in Section 217 of the IR Act and it is required to deduct withholding tax as required under section 65 of the IR Act on such dividends and remit to the Department within the time stipulated in subsection (3) of section 113 of the IR Act.

[IC/2015/19] **[Section 217 – definition of dividends]**

18. Whether the business undertaking of providing some service through a software package could be treated as an undertaking for development of software?

The software development is a process carried out to meet the specific needs of a specific client/business or to meet a perceived need of some set of potential users, and such developed software

is sold to the client (if developed based on the specific requirements) or distribute through retail stores or sold on a per unit basis at a decided price to the buyers. Since the software development is a professional service, any person engages in the business of software development is required to develop software through software engineers specializing in such practices for a variety of purposes as per the need of their clients such as to meet specific needs of a specific client/business or to meet a perceived need of some set of potential users. Once the software package is developed the ownership of the software package is transferred to the potential purchasers (whether developed for specific requirements or for general use by anybody). Therefore, such kind of undertakings could be treated as an undertaking for development of software.

Any software developer/purchaser who develops /purchases such software not for sale but for the purpose of engaging in the business of providing services by allowing potential end users, those who require such services, to use such software through any system owned by the developer/purchaser while retaining the ownership of the software in his name (without transferring), could not be treated as a person carrying on an undertaking of a business of software development but engages in a business of a service provider. As such, the income derived from such an undertaking could not be considered as income generated from development of software but as income generated from providing some service through software developed.

Accordingly, concessionary rate of 10% specified under item 31 of the Fifth Schedule of the IR Act applicable on the profit and income of an undertaking for the development of software could be considered only to the extent of the profits and income from software developed and sold to the end customer. Any other profit and income generated from providing services to telecom

companies, hospitals and booking fees collected from end users etc. are treated as provision of services liable at the normal rates.

[IC/2014/82] **[item 31 of 5th Schedule]**

19. Whether renting out of premises to various enterprises to use such premises for the use of storage facility and supporting services by an individual would qualify for the concessionary rate of 10% applicable to any undertaking carried on in Sri Lanka for operation and maintenance of facilities for storage referred to in item 31 of the Fifth Schedule of the IR Act?

The item 31 of the Fifth Schedule to the IR Act states that the rate of income tax applicable to **any undertaking** carried on in Sri Lanka for **operation and maintenance of facilities for storage**, development of software or supply of labour is as per First Schedule, but subject to a maximum of 10 per centum for an individual, and 10 per centum for a company.

The **undertaking** means a kind of a business and the term "business" has been defined in section 217 of the IR Act. As defined, "business" includes an agricultural undertaking, the racing of horses, **the letting or leasing of any premises including any land by a company** and the forestry ;

Letting or leasing of premises is treated as a business only if such activity is carried out by a **company**. In any other circumstances, profits and income from letting of premises (by any person other than a company) is treated as income from renting of properties [paragraph (g) of section 3] and liable to income tax under section 6 of the IR Act, in which the statutory income from rent (letting of premises) is calculated by deducting rates paid by the owner

and repair allowance of 25% on the balance if such repairs are undertaken by the owner.

Accordingly,

(i) Renting out of warehouses by an individual could not be treated as an **undertaking** for which the concessionary rate of 10% is applicable. The source of income from rent has to be calculated by deducting rates and 25% allowance for repairs (the owner is entitled to deduct this allowance so far as he undertakes the cost of repairs irrespective of the amount of actual cost).

(ii) The other services (if charges separately) could be treated as business income and should be taxed accordingly. Since such services do not fall within the services referred to in section 31 of the Fifth Schedule the concessionary rate of 10% is not applicable.

However, the provisions of section 59B may apply on such income other than the letting of premises based on the level of turnover and the maximum rate may be restricted to 12% whereas, the rent income would be taxed up to the maximum of 24%.

[IC/2014/62] **[item 31 of 5th Schedule]**

20. Whether the concessionary income tax rate of 10% applicable on educational services referred in item 32 of the Fifth Schedule to the IR Act, is applicable to the profit and income derived from conducting seminars?

As stipulated in item 32 of the Fifth Schedule to the IR Act, the rate of income tax applicable to profits and income from **educational services** is, as per the First Schedule, but subject to a maximum of 10 *per centum* for an individual, and 10 *per centum* for a company.

The terms **'educational services'** have not been defined in the IR Act. However, it has been defined in the VAT Act. As defined in section 83 of the VAT Act, **"educational services"** means the provision of services by any person or partnership in relation to education, vocational training or retraining.

The same meaning (even the dictionary meaning is also the same) can be applied for income tax purposes as well. Accordingly, it should be restricted only to profit from provision of education (teaching of any subject) and not to any other connected activities.

The teaching of any subject could even be provided by conducting seminars, but it should be noted that conducting seminars to provide information (awareness programs) in order to get clients is not treated as educational services. Further, the organizers of seminars are not providing any educational service. What is important is to analyze whether the seminar is for the promotion of business or for awareness of the subject matter.

Therefore, the activities should be studied to decide whether such activities could be considered as educational. It is very unlikely that conducting seminars would lead to provide educational services in this type of an activity. One of the criteria in deciding would be the checking of the course context, duration of the course and the kind of the certificate issued to students on completion of the course etc. in order to decide whether the activity is an educational activity.

Accordingly, if it is decided that it is educational service, then as stipulated in above item 32 of the Fifth Schedule to the IR Act, the rate of income tax is applicable on such profits and income.

[IC/2015/02] **[item 32 of 5th Schedule]**

(B). ECONOMIC SERVICE CHARGE ACT, NO. 13 OF 2006

[hereinafter referred to as "ESC Act]

21. Whether the fees received in conducting banking examinations and lectures in connection with the banking sector and annual subscription received from members and students by the Institute (which is an institution exempt from income tax under paragraph (b) of section 7 of the IR Act), are liable to ESC?

In terms of section 2 of the ESC Act, No, 13 of 2006 as last amended by the ESC (Amendment) Act, No. 9 of 2014,

"An Economic Service Charge (hereinafter referred to as " the service charge") shall, subject to the provisions of this Act, be charged from every person and every partnership for every quarter of every year of assessment commencing on or after April, I, 2006 (hereinafter in this Act referred to as "a relevant quarter") in respect of every part of the ***relevant turnover*** *of such person or partnership for that relevant quarter, at the appropriate rate specified in the Schedule I, Schedule II or Schedule III as the case may be to this Act:"*

For the purpose of above section, "relevant turnover" has been defined in paragraph (a) of subsection (3) of section 2 of the said ESC Act which reads as follows:

"relevant turnover" in relation to any person or partnership and to any relevant quarter means the aggregate turnover for that relevant quarter of every trade, business, profession or vocation carried on or exercised by such person or partnership, as the case may be, in Sri Lanka whether directly or through an agent or more than one agent:

Provided that, in relation to any relevant quarter commencing on or after April 1, 2012, where such part of the taxable income as consists of profits from any trade, business, profession or vocation assessed under the provisions of IR Act, No. 10 of 2006 for the year of assessment which ended immediately prior to the commencement of the year of assessment to which such quarter belongs, is more than zero, ***the relevant turnover for such quarter other than any turnover , the profits from which are exempt from income tax*** *shall be deemed to be zero.".*

This Institute is carrying on a business of providing professional services in conducting banking examination and lectures for a fee charged for such services. Apart from that membership subscriptions are collected from the bankers who are members of the institution. As per the interpretation already given by the Department (Please refer to item 31 of PART II of the List of Interpretations Set I) the interpretation of the word "business" for ESC purposes has the same meaning assigned to it in the IR Act. Accordingly, the special meaning given in section 101 for clubs and association should be applicable to ESC as well. As such, the membership subscriptions also form part of the turnover of the institution.

Accordingly, the institution is liable to pay ESC, if the total turnover exceeds the threshold limit for the liability to ESC.

[IC/2013/21] **[Section 2]**

22. Interpretation with regard to the "relevant turnover" to be considered for the calculation of ESC liability of the "ticketing agent".

The turnover of a travel agent could consist of different types of activities such as, inbound tourism, outbound tourism, sale of

tickets, facilitation of clients (both local and foreign) such as providing transport, excursion, etc. The turnover of the activities carried out by the travel agent is the total receipts (whether received or not). However, with regard to the sale of tickets the turnover could be treated as the commission from the sale, where the travel agent sells tickets belonged to an Airline for a commission.

Accordingly, the "relevant turnover" in relation to a "ticketing agent" may be treated as his gross commission received by such agent on such Airline tickets sale and the expenses deductible also treated on the same manner.

However, the same basis could not be applicable for the other activities the company may engage which would be decided according to the facts.

[IC/2014/37]

23. Whether a company registered as an 'offshore company' incorporated within Sri Lanka engaged in procuring products from suppliers outside Sri Lanka and to customers overseas could be treated as exempt from Income Tax under section 13(b) (ii) of the IR Act, No. 10 of 2006, considering the profits of the company as from off shore business which does not in any way involve any goods manufactured or produced in Sri Lanka or any goods imported into Sri Lanka?

In terms of the Companies Act, offshore company cannot do businesses in Sri Lanka. However, for the purposes of Income Tax, mere facts that the registration as an off shore company will not be a conclusive evidence that the business is not transacted in

Sri Lanka. It would depend on the actual activities carried out by the company. (Please see the ruling issued by the Department under PART II of the Interpretation List I).

The activities carried out as a company incorporated in Sri Lanka do not fall as offshore transactions simply due to the facts that goods are procured from one country and exported to another country since the activities are carried out by the company incorporated in Sri Lanka. Thus the provision of sub paragraph (ii) of paragraph (b) of section 13 has no application.

However in terms of paragraph (bbb) of section 13, with effect from any year of assessment commencing on or after April 1, 2012, the profit and income earned in foreign currency by any person in respect of any business of procuring goods from one country or manufactured in one country and exported to another country other than Sri Lanka is exempt from income tax.

Accordingly, the profit and income earned by the company is exempt from income tax in terms of paragraph (bbb) of section 13, on goods purchased from one country and exported to another country, **if the income from such activity is earned in foreign currency.** However, still the facts remain that this is not an offshore transaction but a transaction carried on in Sri Lanka on which only the goods are transferred from one country to other.

As defined in subsection (3) (a) of section 2 of the ESC Act, No. 13 of 2006 “relevant turnover” in relation to any person or partnership and to any relevant quarter means the aggregate turnover for that relevant quarter of every trade, business, profession or vocation carried on or exercised by such person or partnership, as the case may be, **in Sri Lanka whether directly or through an agent or more than one agent.**

Therefore, the business of export of goods (even though it is from one country to other country) is still a business carried on by the company in Sri Lanka and accordingly liable to ESC if the turnover per quarter exceeds Rupees 50 million.

[IC/2015/32] **[Section 13(b) (ii)]**

(C). VALUE ADDED TAX ACT NO 14 OF 2002

[hereinafter referred to as "VAT Act"]

24. A directive on the ascertainment of the value of supply of land and improvement thereon under section 5(7) of the VAT Act, No. 14 of 2012.

In terms of section 5 (7) of the VAT Act,

"The value of supply of land and improvements thereon, shall be the value of such supply less the value of land at the time of supply and the value of any improvements on the land as at March 31, 1998 which shall not be less than the open market value of such supply excluding the value of such land at the time of supply and the value of any improvements on such land as at March 31, 1998."

Accordingly, with regards to land and improvement thereon, the value of supply is the improvement on the bare land and the value addition due to such improvements taken place after 01.04.1998. There is no liability on the market value of bare land. However, the market value on the improvements forms part of the value of supply. The reason for the deduction of the improvements as at March 31, 1998 is that, prior to that date land transactions were taxed under the Turnover Tax regime and therefore, such value need not to be captured under the value added tax scheme commenced from 01.04.1998 as Goods and Services Tax (GST) subsequently changed as VAT.

Based on the calculation of value of supply as stipulated in the above provision, the natural increment of the land would not be liable, as the market value of the bare land is deducted in ascertainment of the value of supply. However, the natural increment of the value addition of the improvement is liable to

VAT. It would automatically be reflected in the calculation of the value of supply, as the natural increment is part of the sale price and the deduction is only be permitted for the land. However, the market value of improvements made to the land such as filing of marshy lands, leveling, escaping, putting roads, supply electricity and water, making boundaries, removing of old structures etc. is part of the value of supply.

[IC/2013/63] **[Section 5(7)]**

25. Whether the activities carried out by an Institute such as promotional services including organization of events could be treated as exempt services for VAT within the provision of educational services in accordance with the VAT Act, No. 14 of 2002 as amended subsequently?

The supply of educational services by any person or partnership is exempt from VAT with effect from January 01, 2011, in accordance with the item (i) of paragraph (b) of the PART II of First Schedule to the VAT Act, No.14 of 2002 as amended by the VAT (Amendment) Act, No. 9 of 2011.

As stated in section 83 of the VAT Act, No.14 of 2002, as amended by the Amendment Act, No. 9 of 2011;

"Educational services" *means the provision of services by any person or partnership in relation to education, vocational training or retraining.*

Accordingly, the 'education' in this context means a process of teaching, training and improving knowledge and developing skills.

The activities carried out by the institution from which the income is derived such as promotional services including organization of events are not purely educational activities but ancillary services. Such activities do not fall within the meaning of educational services defined in the VAT Act as there is no process or continuous element in those activities and they are provided occasionally and whenever the need arises.

Thus, the activities carried out by the institution as promotional services including organization of events could not be treated as educational services for the exemption under the VAT Act and therefore liable to VAT.

[IC/2014/58] [item (i) (b) of PART II of the First Schedule]

26. Whether the free issues made by the company under a sales promotion scheme could be treated as exempt from VAT?

The company offers one table free of charge on purchase of 6 chairs under "Free Issue Package" as a market strategy to defeat the severe competition in the furniture trade. The value of the free issue has been deducted from the invoice at the time of sale and charge VAT on the balance amount. The cost of production of such table is absorbed with other items sold.

Any supply, import or service could not be treated as exempt unless such supply, import or service has been specified in PART II of the FIRST SCHEDULE to the VAT Act, No 14 of 2002. Since free issues have not been specifically mentioned in the aforesaid FIRST SCHEDULE, such free issues are liable for VAT.

However, the company has applied this "Free issue package" as a market strategy and this package is uniformly applicable to all customers who purchase the items under this scheme. Hence, VAT liability on free issues has to be decided based on the facts of the case in which it should be checked whether the market value of free issue has been adjusted in the package of price fixed with the free issue package.

[IC/2013/109]

27. Whether,

i. The import yarn and manufacture fabrics by processing knitting, dyeing and finishing, and supply of such fabrics to the local market and

ii. Dyeing the gray fabric which are received from customers (dyeing and finishing only- Commission dyeing), could be treated as exempt supply under the provisions of VAT Act, No.14 of 2002 (as amended)?

The exemptions applicable under PART II of the First Schedule to the VAT Act are set out below:

(i) The import or supply of yarn used for textile industry and dyes used for the handloom industry, as identified under the Harmonized Commodity Description and Coding System Numbers for Custom purposes [item (xii) of the paragraph (a) of the Schedule];

(ii) The supply of :

(a) locally manufactured fabric in the domestic market by any manufacturer who does not enjoy any concessions under any

agreement entered into with the Board of Investment of Sri Lanka;

(b) fabric which are subject to a cess at a specific rate classified under the Harmonized Commodity Description and Coding System Numbers for Custom proposes, in lieu of chargeability of any other tax on importation at the point of entry into the country, by the Director- General of Customs as specified in a *Gazette* Notification issued under the Sri Lanka Export Development Act, No. 40 of 1979; [Item (xxxvii) of the paragraph (b) of the Schedule]

(c) services, which result in the improvement of quality, character or value of any yarn, fabric or garment so far as such services are provided to persons other than exporters of such products [item (xliii) of the paragraph (b) of the Schedule];

(iii) The import of fabric, specified under the Harmonized Commodity Description and Coding System Numbers for Custom proposes, for the sale in the domestic market without any value addition, subject to the chargeability of a Cess at a specific rate referred to in sub-item (ii) of item (xxxvii) of paragraph (b) of PART II of the First Schedule [item (xxxvi) of paragraph (c) of the Schedule].

Accordingly,

(i) Local supply of manufactured fabric out of the yarn imported is exempted as referred to in item (ii) (a) above, if the company does not enjoy any concession under any agreement entered into with the Board of Investment of Sri Lanka.

(ii) Dyeing of gray fabric received from the customers is a service which results in improving the quality, character or value of the fabric. Accordingly, the exemption is applicable as referred to in item (c) above, if such services are provided to persons other than exporters. The services provided to exporters are not exempted. However, such supply could be facilitated through the application of SVAT Scheme.

[IC/2014/46] **[PART II of the First Schedule]**

28. Clarification with regard to the VAT liability of a recruitment agency engaged in supplying manpower to overseas.

The local agencies that provide foreign recruitments, register with Sri Lanka Bureau of Foreign Employment (SLBFE) for the provision of such services, **need not to be registered for VAT** unless any additional charge, other than the statutory charge fixed by the SLBFE, is collected by such agencies from the individuals who seek for foreign employment through such agencies.

The total statutory fee charged by the SLBFE from each individual who is recruited by the company/agency is liable to VAT in the hands of SLBFE and the VAT is collected by the agent on behalf of SLBFE. The attributable part of such fee received by the recruiting agency from SLBFE is excluding VAT. Since the receipt of the Agent is excluding VAT, no input tax is claimable by the agent. Total VAT collected by the agent on behalf of SLBFE and the VAT on the total taxable supply is declared in SLBFE and the Agents need not to be paid the VAT portion to the company/agency as the VAT on the full bill is paid by the company. The attributable part and connected input tax on such income also not claimable.

Further, if any other charge is collected locally by the company from the individuals in addition to SLBFE fee or if there are any other sources of income, such part is liable to VAT and the connected input tax is also claimable subject to the provisions of the VAT Act.

The local charges, for instance air ticket, statutory charges such as visa fee etc. are treated as reimbursement of expenses on which a markup is not added. Therefore, such kind of receipts cannot be treated as taxable supplies, unless an additional amount is charged locally other than the cost recovered as explained above.

Any income received in foreign Currency for the services rendered to the foreign principal/employer are treated as zero rated supplies subject to the fulfillment of the conditions specified in section 7(1)(c) of the VAT Act, which has to be decided based on the facts of the case by studying the kind of services provided.

Accordingly, recruitment agencies are not required to be registered for VAT unless any additional charge is collected by such agencies from the individuals and therefore SLBFE will not make the VAT portion to the agency. Hence VAT liability will not be arisen to the agency on that income.

[IC/2014/27] **[Section 7(1)(c)]**

29. Whether a service provider who provide consultation and other services including marketing services to the foreign recipient who sells its products directly to its distributors in Sri Lanka and receives its consideration for the services rendered in foreign currency through a bank in Sri Lanka, can register under Zero Rating for the purposes of VAT under section 7(1) (c) of the VAT Act, No. 14 of 2002?

Section 7(1) (c) of the aforesaid VAT Act provides;

"any other service, being a service not referred to in paragraph (b), provided by any person in Sri Lanka to another person outside Sri Lanka to be ***consumed or utilized outside Sri Lanka*** *shall be zero rated provided that payment for such service in full has been received in foreign currency from outside Sri Lanka through a bank in Sri Lanka."*

In the above section it is clearly stated that, **the service should be utilized or consumed outside Sri Lanka** to be eligible to consider as zero rated supplies. The Registration as a zero rated supplier is decided if such conditions are satisfied.

The following facts should be taken in to consideration in order to decide whether a service is utilized out of Sri Lanka.

The utilization of services will depend on the fact that the place where the taxable activity carried out and to whom the services are provided. If the person outside Sri Lanka does a business in Sri Lanka through a person in Sri Lanka, such services are not treated as services utilized outside Sri Lanka, even though the recipient of the services is not physically present in Sri Lanka, to utilize the service.

If the recipient of service is out of Sri Lanka, and sells its products directly to the distributors in Sri Lanka. Then the benefit of such service accrues in Sri Lanka and not in other country since such services are utilized in the course of carrying on or carrying out a business in Sri Lanka through distributors by recipient of such service. Therefore the services provided by the company to recipient are not treated as services **utilized or consumed** outside Sri Lanka. Hence registering the company for VAT under Zero Rated is not permitted.

[IC/2013/33] **[Section 7(1) (c)]**

(D). NATION BUILDING TAX ACT NO 09 OF 2009

[hereinafter referred to as "NBT Act"]

30. Interpretation with regard to the NBT liability after 01.01.2011, on processing of rice flour

As stipulated in sub paragraph (b) of paragraph (iv) of sub section (4) of section 3 of the NBT Act, if the liable turnover of a person who engages in the processing of any locally procured agricultural produce in the preparation for sale, for any quarters commencing on or after 01.01.2011 exceeds Rs. 25 million, is liable to NBT.

As stated in the aforesaid section, process should be made to the locally procured agricultural crops. "Locally procured agricultural crops" means the crops obtained through local cultivation. Accordingly, any process made using the already processed products could not be treated as "**processing of any locally procured agricultural produce"**

Hence, though the rice production from paddy is fallen within the meaning of "process of agricultural crops into the market", other products made using rice (already processed product) are not fallen within such meaning.

Accordingly, as the process of making rice flour using rice is not fallen within the meaning of "the processing of agricultural produce in the preparation for sale," the NBT liability on such manufacturers will arise as follows.

If liable turnover of that person for any quarter

- commencing prior to January 1, 2011 exceed the sum of six hundred and fifty thousand rupees;

- ❖ commencing on or after January 1, 2011 but prior to January 1, 2013; exceeds the sum of five hundred thousand rupees;
- ❖ commencing on or after January 1, 2013 but prior to January 1, 2015; exceeds the sum of three million rupees;
- ❖ commencing on or after January 1, 2015; exceeds the sum of three million seven hundred and fifty thousand rupees;

[IC/2014/60] **[Section 3(4)(iv)(b)]**

31. Whether the Manufacturer who engages in manufacturing of packaging items and sold such products to the local market as well as to the exporters (Deemed exports), is eligible to claim input tax relating to deemed exports against the NBT payable on sales under NBT Act, No.9 of 2009?

As provided in section 6 of the NBT Act,

"Where any person to whom this Act applies, utilizes wholly or partly any goods purchased from a manufacturer registered for payment of tax under this Act or imported by himself, in the manufacture of goods liable to tax under this Act, such manufacturer shall be entitled to tax credit in respect or such tax paid on such goods in proportion to the value of goods manufactured by such person which are liable to tax under this Act:

Provided that where such credit for any relevant quarter exceeds the tax so payable for that quarter, the excess shall be deemed to be an advance payment of tax paid under section 4 for the quarter immediately succeeding that relevant quarter"

As stipulated in the above section, manufacturer is entitled to claim input tax credit on goods purchased from a manufacturer or imported by himself in the manufacture of goods liable to NBT in proportion to the value of goods manufactured by such person which are liable to NBT.

As per item (ii) and (iii) of PART I of the First Schedule to the NBT Act,

(ii) any article not being plant, machinery or fixtures imported by any person exclusively for use in, or for, the manufacture of any article for export and

(iii) any article sold by any person to whom this Act applies to any exporter, if the Commissioner General is satisfied on the production of any documentary evidence that-

i. such article; or
ii. any other article manufactured, of which such article is a constituent part,

has in fact been exported from Sri Lanka by such exporter directly or through a trading house established for export purposes (with effect from January 1, 2009),

could be treated as an excepted article if such importer or purchaser himself is involve in manufacturing and exporting such manufactured goods.

Therefore, Imports and local purchases made by an exporter are treated as excepted articles for NBT; hence the claiming of tax credit on such purchases does not arise under any circumstances.

On the other hand, deemed exporters who sale manufactured goods to exporters are not eligible to such exceptions. Hence purchase value of local goods and imports may include NBT which deemed exporters have to pay.

Additionally, as stipulated in *item (iii) of part I of the aforesaid Schedule*, any article sold by any person to whom this Act applies to any exporter, is excepted.

Accordingly, since NBT payable by any deemed exporter on purchases and imports are not excepted under aforesaid First Schedule to the NBT Act and sales made by the deemed exporters are excepted, such deemed exporters are not eligible to claim input tax relating to deemed exports against the output tax on sales which are liable to NBT under the NBT Act.

[IC/2014/54] [Section 6 & items (ii) & (iii) of PART I of the First Schedule]

32. Whether the NBT exemption is applicable on the importation of goods under item (xvi) of PART I and on the local services provided under item (xxv) of PART II of the First Schedule to the NBT Act, No. 9 of 2009, to the Project which has been identified by the Minister of Finance as a specified project and the project is funded by foreign funds received by the Government?

In terms of item (xvi) of PART I of the First Schedule to the NBT Act, any goods imported or supplied to a specified project carried on, out of foreign funds or donations received by the Government, **as approved by the Minister considering the economic benefit to the country** is treated as excepted article, whereas, in terms of item (xxv) of PART II of the First Schedule to the NBT Act, services provided to any specific project carried on, out of foreign funds or donations received by the Government, **as approved by the Minister considering the economic benefit to the country** is treated as excepted services for NBT purposes.

Such exclusion of the liability specified in the above paragraph does not apply in general to all the specified projects but applicable only subject to the conditions that the **Minister considers the exclusion considering the economic benefit to the country.**

Therefore, applicable exemptions for the project are depending on the conditions specifically granted to each project by the Department of Fiscal Policy of the Ministry of Finance and Planning as approved by the Minister of Finance.

Besides, it should also be noted that NBT is part of the price and payable by the supplier of goods or the provider of services which cannot be exempted.

[IC/2014/56] [item (xxv) of PART II of the First Schedule]

33. Whether the handcrafts and ornamental items sold under Foreign Exchange Permit issued by the Central Bank of Sri Lanka could be treated as exempt from NBT under category of "gems or jewellery" referred to in sub item 3 of item (iv) of sub section 2 of section 3 of NBT ACT?

As stipulated in sub item (3) of item (iv) of sub section (2) of section (3) of the NBT Act, No. 9 of 2009, gems or jewellery, if sold on the payment of foreign currency by any person authorized by the Central Bank of Sri Lanka to accept payment in foreign currency does not form a part of liable turnover with regard to the business of wholesale or retail sale of any article referred to in paragraph (d) of subsection (1) of section 2, for the calculation of NBT.

However, **Handcrafts and ornamental items** do not fall within the meaning of *gems or jewellery* referred under aforesaid section 3. Therefore, even though the company has fulfilled the other requirements specified under above section 3, such turnover could not be excluded from the turnover, hence, form a part of the liable turnover. As a result such part of the turnover is liable for NBT.

However, according to the insertion of sub item 9 of item (iv) of sub section (2) of section 3, to the NBT Act by NBT (Amendment) Act, No. 10 of 2014, retail sale of any article at duty free shops for payment in foreign currency will not be a part of liable turnover for the calculation of NBT.

As such, on the retail sales of handcrafts and ornamental items made at duty free shops on or after 1st January, 2014, for payment in foreign currency are not liable for NBT, so far as such sale is not manufacturing and selling and in so far as the said payments are received in foreign currency.

[IC/2014/84] **[Sections 3(2)(iv)(3) & 3 (2)(iv)(9)]**

34. Whether the income derived from mining and selling of raw gems, mining and selling of polished gems through Auction of Gem and Jewellery Authority and other sales made by any person could be exempted from NBT?

The turnover from sale of gems is liable to NBT irrespective of the manner in which it is sold.

Apart from that, in terms of item (3) of paragraph (iv) of subsection (2) of section 3 of the NBT Act, No. 9 of 2009, in a case of a wholesale or retail business, the turnover from the sale of gems or jewellery, if sold on the payment of foreign currency

by any person authorized by the Central Bank of Sri Lanka to accept payment in foreign currency is exempt from NBT.

Further, if the gems and jewellary are exported or supply to an exporter the exemption is applicable both as a manufacturer or a wholesale and retail seller.

[IC/2015/25] **[Sections 3(2)(iv)(3)]**

35. Whether the exemption on supply of educational services including conducting seminars is exempt from NBT?

Educational services have not been exempted for NBT. However, in terms of section 3(4)(iv) of the NBT Act, No. 9 of 2009, the liability does not arise, if the liable turnover of a person in providing educational services by any institution established locally for that purpose does not exceed the sum of twenty five million rupees

Accordingly, the turnover from conducting seminars (even if it is treated as educational) is liable to NBT unless the provider has any institution established locally for provision of educational services.

[IC/2015/02]

(E). CONSTRUCTION INDUSTRY GUARANTEE FUND LEVY (CIGFL)

PART III of the Finance Act, No. 5 of 2005 as amended by the Finance (Amendment) Act, No. 18 of 2009

36. Interpretation of 'contract value' as per section 20 of PART III of the Finance Act, No. 5 of 2005 as amended by the Finance (Amendment) Act, No. 18 of 2009, in a case where several contracts are undertaken by one contractor (under one project) for the purposes of application of the rate specified in the Second Schedule of the said Act for deduction of Construction Industry Guarantee Fund Levy (CIGFL).

As defined in section 20 of PART III of the Finance Act, No. 5 of 2005:

*"Contract value" means the amount or the **amounts** stated in the **letters** of acceptance and which are thereafter adjusted in accordance with the provisions of the contract. The said **contract value** shall be the **sum total of individual contracts or of several contracts** which have been entered into in respect of the carrying out of any construction work and shall include sub-contract values and such other construction costs that may be incurred in carrying out such works, but shall not include any Value Added Tax payable under the Value Added Tax Act, No. 14 of 2002."*

Accordingly, the words "**contract value**" referred to the aggregate of more than one contract, in a case of a contractor who/ which carries on more than one contract, irrespective of the fact that the contracts are different types whether or not inter connection, but so far as such contracts are for construction work.

[IC/2014/75]

(F). STAMP DUTY (SPECIAL PROVISONS) ACT, NO. 12 OF 2006

[hereinafter referred to as "SD Act"]

37. Whether the exemption on Stamp Duty referred to in item 5 of the Gazette Notification dated October 05, 2006, is applicable with regard to a conversion of preference shares in to ordinary shares which does not result in change of ownership of shares, increase of share capital and no cash inflow to the company?

In terms of section 3 of the SD Act, Stamp duty is charged on every "specified instrument";

- executed, drawn or presented in Sri Lanka; or
- executed outside Sri Lanka being an instrument which relates to property situated in Sri Lanka, at the time such instrument was presented in Sri Lanka.

As specified in paragraph (f) of section 4 of the SD Act *"**a share certificate on new or additional issue or on transfer or assignment"*** is a "specified instrument" liable to Stamp Duty.

The exemption on Stamp Duty referred to in item 5 of the Gazette Notification No 1465/20 dated October 05, 2006 issued under section 5 of the SD Act states that,

"*Any share certificate issued in lieu of share certificate lost or destroyed, or **new share certificate for a greater or less number of shares in lieu of existing share certificates but not exceeding in value of the existing share certificates."***

Accordingly, for the eligibility of the above exemption, new share certificates should be for a greater or lesser number of shares in

lieu of existing share certificates. However, in this event of converting of preference shares into ordinary shares, there would be no addition or deduction to the number of shares in the stated capital but change in rights. Therefore, the aforesaid exemption will not be applicable in this situation.

[IC/ 2014/63]

(G). LAND (RESTRICTION ON ALIENATION) ACT, NO. 38 OF 2014

38. Whether the exclusion of the application of the provisions of Land (Restriction on Alienation) Act, No. 38 of 2014 applicable to Diplomatic Missions could be extended to Diplomatic staff as well?

In terms of section 3 of the Land (Restrictions on Alienation) Act, No. 38 of 2014, the restriction of transfer of land referred to in that Act does not apply to a Diplomatic Mission of another State within the meaning of the Diplomatic Privileges Act or to an International, Multilateral or Bilateral Organization recognized in terms of that Act.

Similarly, in terms of section 7 of the said Act, land lease tax payable under section 6 of the Act shall not be applicable on the lease of any land (including house or building) to a Diplomatic Mission of another State within the meaning of the Diplomatic Privileges Act or to an International, Multilateral or Bilateral Organization recognized in terms of that Act;

Accordingly, any land transaction made to a Diplomatic Mission or to any organization for which the Diplomatic Privileges Act, No. 9 of 1996 applies, the restriction/ liability to land lease tax is not applicable. However, the said Act has not covered the Diplomatic personnel, hence alienation of land to diplomatic staff is prohibited or if it is a lease, land lease tax will be imposed as per the provisions of the Act.

[IC/ 2015/15]