

Income from Property

There are two sources of property income identified in the Inland Revenue Act.

1. Properties owned and occupied - Net annual value.
2. Properties rented – Rent income.

Net Annual Value

This is a notional income from property, which is not earned in monetary terms. NAV may be chargeable on

- Land and Improvements
- Place of residence.

Only the **owners** and **occupiers** are chargeable with tax under this source.

Owners will be chargeable when

- Owner himself occupies the property.
- Someone else occupy the property on behalf of the owner ex. Family members

Occupiers will be chargeable when

- If he occupies the property free of any rent.
- Occupier pay a rent below the NAV – here the difference between the rent paid and the NAV will be chargeable for tax, as occupier's income.

Exclusions

Land and improvements used for the purpose of Trade, Business, Profession or vocation will not be charged for tax.

Calculation of NAV

	Rs.
Rating assessment	XXX
Less : 25% allowance for repairs	<u>(XX)</u>
NAV	<u>XXX</u>

If the rating assessment is not accepted by the Department, the commissioner general may compute the NAV on the basis of the rent which a tenant may reasonably expected to pay, subjected to deduction of 25% allowance for repairs.

Exemptions

1. One place of residence

NAV of one place of residence owned and occupied by an individual will be exempt. If a person owns and occupies more than one house, the highest NAV of the house could be taken for exemption.

2. Newly constructed house

I. Houses completed prior to 01 April 2003

With floor area less than 1500sqft will be exempt for the year of assessment in which it was completed and **nine** succeeding years of assessment.

II. Houses completed between 01 April 2003 and 01 April 2008.

If the floor area of the house is more than 1500sqft will be exempt for the year of assessment in which it was completed **and four** succeeding years of assessment.

If the floor area of the house is less than 1500sqft will be exempt for the year of assessment in which it was completed **and six** succeeding years of assessment.

III. Houses completed on or after 01 April 2008

If the floor area of the house is less than 500sqft will be exempt for the year of assessment in which it was completed **and four** succeeding years of assessment.

3. Conversion into residential units.

This is where a house with a taxable income is converted into two or more residential units, with two separate rating assessments, will be exempt on the following basis

i. If the floor area is less than 1000sqft, year of assessment in with the conversion was effected and **five** succeeding years.

ii. If the floor area is less than 2000sqft, year of assessment in with the conversion was effected and **three** succeeding years.

Rent Income

Computation of Net Rent

	Rs.
Gross rent	XXX
Less : Rates born by the owner	<u>(XX)</u>
	XX
Less : 25% allowance for the repairs and other expenses	<u>(XX)</u>
Net rent	<u>XXX</u>

In order to claim the deductions, the rates and the repair expenses has to be borne by the owner. 25% allowance is given regardless of the actual expense. Department can verify with the rent agreement.

The net rent should not be less than the net annual value. If so NAV should be treated as rent income.

However if the NAV is higher than the gross rent received, only the gross rent will become chargeable to the owner. The balance or the difference between the gross rent and the NAV will become occupier's income.

Example

Mrs. Silva owns the following properties of which the details are given for 2013/14.

- No. 06, Havelock Road, Colombo 05 – Rented to a business for a monthly rent of Rs. 15,000 and occupied by the tenant throughout the year. Colombo municipal councils rating assessment is Rs. 25,000 per quarter and she pays Rs. 2,500 as rates for each quarter. In addition she has spent Rs. 22,500 on repairs and maintenance.
- No. 28 Jaya Mawatha, Bambalpitiya – Residential property which she occupy as her residence. CMC rating assessment Rs. 20,000 per quarter and pays rates of Rs. 2,000 per quarter.
- No 30 Jaya Mawatha, Bambalapitiya, - Occupied by her daughter on her behalf. CMC rating assessment is Rs. 17,500 per quarter and pays rates at Rs. 1,750 per quarter.
- No 135 Kohuwala Road, Nugegoda, rented to a relative Mr. Sam at Rs. 10,000 per month. Municipal councils rating assessment is Rs. 50,000 per quarter and she pays rates at the rate of Rs. 5,000 per quarter.
- No. 564 Pamunuwa Raod, Maharagama, - a shop rented to a business for 6 months for a rent of Rs. 12,000 per month. Council rating assessment is for Rs. 15,000 per quarter and paid rates at Rs, 1,500 per quarter.

Calculate Mrs. Silva's property income and any occupiers income.

Exemptions

Newly constructed house

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*****If a per acquires a house during the period of exemption as detailed above, he can claim the balance exemption period, given to the house, even though he may not be the person who constructed it.**

Deduction of withholding tax

When a person pays rent to a person or partnership outside of Sri Lanka, should deduct a tax of 20% from the amount of rent and remit directly to the commissioner general. The recipient can obtain a direction for reduced tax deduction.

The person who deducts the WHT should issue a certificate, and the recipient can claim tax credit by production of WHT certificate.

Occupier's income

As discussed earlier the occupier's income will tax under a different source.

	Rs
NAV	XXX
Less : Rent paid by the occupier	<u>XX</u>
Occupiers income	<u>XXX</u>

Exclusions

- a) A person occupies in a trade, business, profession or vocation
- b) Person occupies on behalf of the owner
- c) Occupies a house provided by the employer

Employment Income

Tax is charges on employment income provided that there's

- a) Employer employee relationship
- b) Payment is made for services of employment

Employer employee relationship

Contracts of services

- Degree of control exercised over the person doing the work.
- Whether the worker must accept further work.
- Whether the person who offered work must provide further work.
- Whether the worker provide his own equipment.
- Whether the worker is entitle to employment benefits as sick pay, holiday pay est.
- Whether the worker hires his own helpers.
- What degree of financial risk and responsibility for investment and management the worker take.
- Can the worker profit from sound management.
- Whether the worker can work when he chooses

Example :

Nick works as a brick layer for a construction company. He works every day from 9.00 am to 5.00 pm. The employer decides the method of work and provides the required equipment. He gets paid for number of bricks laid by him where he invoices the company at the end of each week. The company is not obliged to provide him continuous work.

Ascertain whether Nick is employed or self employed.

Cases

Edward v Clinch 1981

Hall v Lorimer 1994

Carmichael and Anor v National Power plc

Norman Edward Weerasooriya v CGIR

Other occasions

- Partner in a partnership is not an employee
- Agent working for a principle – case by case basis
- Director is an employee of the company

Payment for service of employment

The payments under a contract of employment, present or past will be regarded as profit from employment. However all the payments received by the employees will not be taken as employment income for tax purposes.

Sutherland v Commissioner of income tax

Craib v Commissioner of Income tax

Employment income may be charged under the following categories

1. Regular cash benefits
2. Non cash benefits
3. Payment to any other person for the benefit of employee etc
4. Value of conveyance
5. Retirement benefits
6. Rental value

Regular cash benefits

- Salaries and wages (taxable)
- Allowances (taxable)

Exemptions

Reimbursement of official expenses
Vehicle allowance up to Rs. 50,000 per month
Allowance paid for travelling outside Sri Lanka for employment

- Pension (Exempt)
- Leave pay (taxable)
- Fees (taxable)
- Commissions (Taxable)
- Bonus (taxable on receipt basis)
- Gratuity (taxable)
- Perquisites (taxable)
- Any other payment in money (taxable)

Non cash benefits

Any non cash benefit paid to an employee will be taxable.

CIR v J.De.Fonseka

Value of non cash benefits

Should be the market value if available or the cost

Certain values are specified in the gazette

01. Transport facilities

Motor vehicles for private use- per month

	1500cc Or more	Below 1500cc
i. Driver with fuel	50,000	35,000
ii. Fuel without driver	35,000	25,000
iii. Driver without fuel	30,000	20,000
iv. Without driver and fuel	15,000	10,000

Motor cycles	
Provided with fuel	Rs. 5,000
Provided without fuel	Rs. 3,000

Where accurate record of private millage is maintained

- For motor vehicles Rs. 15 per km
- For motor cycles Rs. 3 per km

For reimbursement of expenses by the employer – the actual value reimbursed will be the benefit.

02. Company shares awarded to employees

The market value at the date of allotment will be assessed as a benefit.

03. Provision of servants, electricity, gas, free meals, life insurance and air tickets

100% of the cost to the employer

04. Medical benefits

100% of cost at the time payment

05. Payment of telephone bills

50% of cost

06. Hotel facilities for expatriates

25% of the cost for the first three months and 100% thereafter

07. Payment of taxes

Exemptions

01. Once motor vehicle provided for private use or Rs. 50,000

02. Free transport by motor coach

Payment to any other person for the benefit of employee etc

These are taxable employment benefits if connected with the services for the employer.

Ex. Employer's contribution for pension fund. These may include payments received from third parties as well.

Case – Kanagasabapathy v CGIR

Value of conveyance

Will be taxable 100%

Retirement benefits

Payment of retirement benefits – will be taxed in the assessment year in which the retirement takes place.

Please refer tax rates for once and for all receipts on employment.

In addition an exemption of Rs. 2,000,000 as compensation for loss of office or employment provided

- The voluntary retirement by an employee in accordance with a scheme which in the opinion of the commissioner general is uniformly applicable to all employees
- The retrenchment of an employee in accordance with a scheme approved by the commissioner of labour

Sum paid to an employee's provident fund by an employer will not be taxable.

Rental Value

Taxable rental value

01. Rating assessment + rates paid by the owner or
 02. Gross rent paid by the employer
- Which ever is higher

If the total employment benefits of the employee is less than Rs. 1,800,000 (other than conveyance and retirement benefits) the maximum chargeable rental value would be Rs. 120,000 and if it's in excess of Rs. 1,800,000 the maximum would be Rs. 180,000

Other additional housing benefits

- ✓ House is furnished – Same as above plus 2.5% of gross remuneration subject to maximum of Rs. 1,500 per month.

- ✓ Place situated in unrated area – 10% of gross remuneration subject to maximum of Rs. 3,000 per month
- ✓ Estate bungalow – 7.5% of gross remuneration or Rs. 2,000 p m whichever is lower
- ✓ Reimbursement of connected expenses – actual amount reimbursed will be assessed.

Computation of profits from employment

	<u>Rs.</u>
Total benefits as discussed above	XXX
Less : Bad debts	(XXX)
Employers contribution to pension, provident or savings fund	<u>(XXX)</u>
Total employment benefits	<u>XXX</u>

******Exemptions : please refer the act and the relevant text books**

Profits from Trade, Business, Profession or Vocation

Every person in trade, business etc should prepare income statement for every year of assessment ended 31st March.

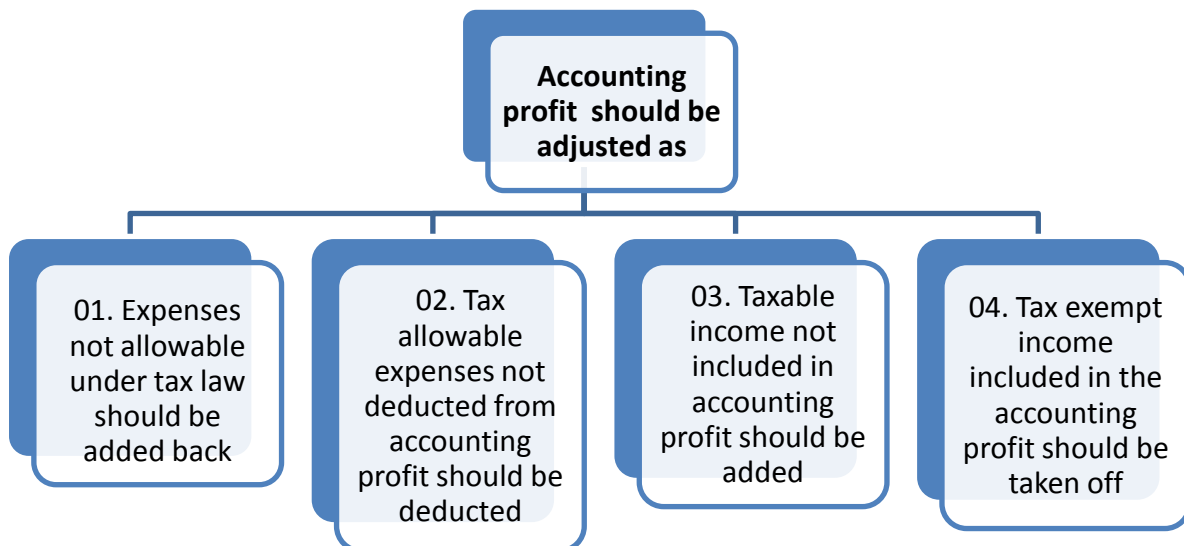
The net profit before tax of the income statement as prepared above should be adjusted according to the taxation rules, before you take the trading profit to the tax computation.

Therefore you need to convert the accounting profit to tax adjusted trading profit on the following basis.

Badges of trade “SOFIRM”

- The subject matter of the transaction (S)
Asset must have been acquired for one of three reasons.
 01. Investment – Capital nature and not subjected to income tax
 02. Private use – not subjected to tax
 03. Trade inventory – Subject to income tax
- The length of the period of ownership. (O)
- The frequency of similar transactions by the same person. (F)
- Supplementary work, improvements and marketing. (I)
- The reason for the sale. (R)
- The motive. (M)

Adjusting the accounting profit



- Adjustments should be made to the accounting profits which is prepared under the accounting standards and GAAP's in order to bring them in line with the taxation rules. This is called the calculation of tax adjusted profit.

Following adjustments should be done to the accounting profit to ascertain the taxable profit.

01. Expenditure which are disallowed by the tax law, being deducted in the calculation of accounting profit should be **added back** to the accounting profit

02. Taxable trading income which are not included in the income statement should be **added** to the accounting profit.

03. Expenditure that is deductible for tax purposes but not charged in the calculation of accounting profit should be **deducted**.

04. Income which are included in the income statement being non taxable should be **deducted** from the accounting profit.

Trading Income

If part of income or profits is exempt from income tax or taxable at different rates, that person shall prepare and maintain separate accounts for such types of activity.

Case – Rodrigo v CGIR (2002 SC)

Section 106(11)

Excluded income

- Receipts from other sources
- Exempt subsidies etc
- Receipts of capital nature

Disallowable expenses

Expenses and outgoings incurred in the production of income, that are incidental to the trade or business or which has a direct purpose of earning the profits can be deducted.

- Incidental to the trade or business
Heyley and Co Ltd V CIT
- Direct purpose of earning a profit
CIR v A.W.Davith Appuhamy

- Reserves, Provisions and notional expenses are not allowed
- Special provisions allowed
- Lease rental no deductions due
- Bad debts – deduction is allowable to the extent that the debt has become bad in respect of the supply of goods and services and Doubtful debts to the extent they are estimated to have become bad.

Ex . The income statement of Mary for the year ended 31 March 2014 includes a figure for impaired debts of Rs.30,000. This is made up as follows.

	Rs	Rs
Trade debts written off		52,000
Loan to former staff written off		28,000
Allowance for impaired debt As at 1 July 2012	90,000	
As at 30 June 2013	70,000	

		(20,000)
Trade debts recovered		(40,000)
Loan to supplier written off		25,000
Loan to customer recovered		(15,000)

		30,000

Loan to customer recovered relates to a loan written off two years ago.

Make the necessary adjustments to the tax allowable profit

- Interest not incurred not in production of income and profits should be added back.
- Expenditure on residence provided to the employees are disallowed on the following basis.
 - Excess of expenditure over the amount included in the employment income of the employee. – 50% of excess if the emoluments of the employee is less than Rs. 600,000 p.a
75% of excess if the emoluments of the employee exceeds Rs. 600,000 p.a
 - Expenditure on any asset provided to an employee to be used in such residence.
 - Expenditure on any movable or immovable property given to employee at less than the market value.
 - Loan, advance or credit granted to employee which is subsequently written off.

Ex,. Mr. Vitharana is an executive of a leading bank. His emoluments are as follows
Monthly salary Rs. 60,000

Residence in Colombo 10 rented at Rs. 25,000 (employer pays 2/3 of rent), this residence is rated by CMC at Rs. 90,000 with rates at 30%.

Calculate the amount of disallowed expenditure.

- Repairs are generally allowed, but should be of a revenue nature. Initial repairs to bring the asset into working condition is considered as capital expense.
cases

- Travelling expenses

Vehicles used partly for business and partly for travelling – pro rata basis on business related travelling allowed.

Expenses incurred for non business purposes, lease rentals, cost of acquisition etc disallowed.

- Travelling outside Sri Lanka disallowed other than the following
 - Promotion of exports
 - Provision of services for payment in foreign currency
 - A company exclusively providing services of design, development or product innovation after 01.04.2012
 - Promotion of tourism
 - Cost of passage to Sri Lanka for persons brought for employment
 - Cost of passage to Sri Lanka for persons brought for consultation
 - Expenditure on employees sent abroad for training
 - Accreditation expenses
 - For companies owning estate outside Sri Lanka
- Licence fees

Licence fees are allowable

¾ of payments for obtaining a licence for any manufacturing process in a trade or business should be added back.

- Annuities, royalties etc are not deductible. – but allowed elsewhere.
- Sum recoverable under a contract of insurance is not deductible unless that income is treated as a receipt.
- Stamp duty on capital transactions not allowed
- Certain startup expenses may be deductible provided they are of revenue nature.
- Advertising expenses 25% disallowed
- Tax payments not allowed
- Research and development expenses – 300% allowed provided research is carried out through government institution, else 200% including capital expenditure allowed to be deducted.
- Subscriptions and donations not allowed other than trade related.
- Legal expenses of capital nature not allowed

- Formation of a company – the following expenses are not allowed
 - Expenses of foreign collaborators visiting Sri Lanka for consultations.
 - Cost of feasibility reports
 - Staff recruitment, training, remuneration and setting up of accounting systems

- Penalties and fines on infringing the law – not allowed

- Intangible assets used in the business other than goodwill – 10% of the payment is allowed.

- Embezzlements by employee allowed if it was incurred incidental to the carrying on the business and such sum was part of the circulating capital.

- Computers – allowable for depreciation allowance, hiring of computers and staff training allowed

- Management fees

Management fees are fully allowed for Unit trusts, mutual funds and venture capital companies. For other persons, restricted as follows

 - Rs. 2 Million or 1% of turnover which ever is lower or
 - Such amount determined by the commissioner general as being reasonable and commercially justifiable.

Which ever is higher

- Management fees in the nature of head office expenses, of a nonresident company is restricted to the lower of
 - 10% of taxable income or
 - Actual expense

Pension funds are not entitled to claim any management expenses.

- Lump sum payment in letting or leasing commercial premises

Should be taken proportionately, what is relevant to the year of assessment.

Ex. ABC Company started a retail business in Pettah. They entered into lease agreement with a land lord as follows.

ABC company would pay Rs. 1,200,000 immediately and a rent of Rs. 10,000 per month starting from 01.01.2014 for the next five years.

Calculate the amount allowable for the year of assessment.

- Expenditure on production of films

When the production of film commences in one year and the exhibition is in a subsequent year, the expenses in the first year will be carried forward as working progress.

No deduction allowed as losses from other income in the first year.

- Quotation expenses

Quoting shares of a company in the stock exchange is deductible provided, aggregate of the expenditure does not exceed 1% of the IPO.

- Capital expenditure not allowed

Samuel Jones & Co Ltd v CIR - 1951

Brown v Burnley Football and athletic club - 1981

Law shipping company v CIR – 1923

Odeon Associated theatres Ltd v Jones 1971

- Aggregation of income of spouses

Not deductible, even in partnerships where one spouse is a partner

Allowance for depreciation

Rates of allowance for depreciation

- Plant, Machinery and equipment	33 1/3%
- Information technology equipment and software	25%
- Software developed in Sri Lanka	100%
- Any motor vehicle or furniture	20%
- Bridges. Railway tracks, reservoir, electricity or water line etc	6 2/3%
- Qualified buildings	10%
- Ships	33 1/3 %
- Machinery used in construction industry	33 1/3 %
- High-Tec plant and equipment	50%

Ex : Mc Donalds is in the business of supplying fruits and vegetables for the financial year 2013/14. The accounting profit of the company was Rs. 3,500,000/-. The following expenses were incurred in calculating the accounting profit. This is its first year of operations.

Entertainment	Rs.125,000
Advertising and marketing	Rs. 300,000
Motor vehicle hiring	Rs. 85,000
Staff welfare	Rs. 15,000

Rent paid	Rs. 100,000
Subscription	Rs. 150,000
Salaries and bonus	Rs. 550,000
Interest on overdraft	Rs. 155,000
Foreign travel	Rs. 100,000
Purchases	Rs. 530,000
Repairs and maintenance	Rs. 75,000
Depreciation	Rs. 900,000

Following assets were purchased during the year

Cool room –	Rs. 2,000,000
Freezer truck	Rs. 4,000,000
Computers	Rs. 200,000
Furniture	Rs. 150,000

Additional information

- Advertising and marketing expenses include Rs. 50,000 for marketing.
- Subscription includes owners golf club subscription of Rs. 112,000
- Foreign travel was for a private visit by the owner
- Repair and maintenance include Rs. 60,000 for the repair of coolroom to bring it to a working condition.

Calculate the tax adjusted profit for the above company