

TAXATION OF COMPANIES

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The taxation of companies assumes great importance to a country like Sri Lanka because 70 percent of the income tax revenue comes from companies. From 1932 upto 1958 the system of taxation adopted in Sri Lanka for the taxation of companies was the imputation system. In 1958 with the introduction of the Kaldor system of taxation, the classical system was adopted. The Minister of Finance in his budget speech for 1988 has announced that as from 1st April 1988 companies will be taxed on the imputation system.

In the classical system of taxation companies are treated as separate legal entities and are taxed on their profits. When the shareholders are paid a dividend the companies have to pay a dividend tax. Under this system there is what is called "economic double taxation". Under the imputation system companies pay only one tax and the shareholders receive credit for the tax paid by the company. The system is called the 'imputation system' because when dividends are paid the tax is allocated to individual shareholders. The profits and tax paid by the company in which they own shares.

Each of these systems has its relative merits and demerits. The classical system has the effect of discriminating in favour of debt rather than equity. New equity becomes more expensive than new debt because interest income is taxed only once, while dividends are taxed twice. Secondly, the double taxation of dividends could induce companies to retain rather than distribute their profits. Thirdly, the high tax burden under the classical system can inhibit the formation of companies, with a shift towards unincorporated business organizations, such as partnership. There are equally compelling arguments in favour of the classical

system. In developing countries where the capital market is rudimentary, the necessary funds must come from within the enterprise itself as reserves. Under the classical system, companies are encouraged to build up reserves rather than distribute their profits as dividends. Another serious difficulty with an imputation system arises in the international context. Should foreign shareholders be given the same credit that is given to resident shareholders? If this is permitted, it would be at a very high revenue cost. The yield from the taxation of companies under the classical system is far in excess of the yield under the imputation system. As mentioned earlier, Sri Lanka derives over 70 percent of its revenue from companies. Although representations were made to the Taxation Commission in 1966 for the introduction of the imputation system the Commission did not accept the suggestion for the reason that there would be loss of revenue.

In this context, the decision of the Minister to introduce the imputation system is a bold step. The introduction of the system will certainly encourage company formation and encourage the small investors to invest their savings in companies that can now give a better return to these investors by way of dividends.

The imputation system of taxation is applied in the United Kingdom, Malaysia, Singapore, Germany, France and several other countries. Australia which had the classical system has changed over to the imputation system as from 1st July 1987. New Zealand is to introduce the imputation system shortly. In Australia, Malaysia and Singapore, the system adopted grants full imputation. In UK, Germany and France, however, there is only 'partial imputation'. In Sri Lanka the Minister

of Finance has proposed a 50 percent imputation. The legislation giving effect to this proposal is to be introduced shortly and it is hoped that the shifting from the classical system to the imputation system will be done smoothly.

TAXATION MEASURES

Fourteen major taxation measures introduced with the Budget Proposals 1988 may be summarised as follows:

Reduction of the Maximum Rate of Personal Tax

The maximum rate at which individuals are liable to tax is to be reduced from 50% to 40% from the Year of Assessment 1988/89. The new slabs will be as follows:

First Rs 21,000	- 10%
Next Rs 24,000	- 20%
Next Rs 24,000	- 30%
Balance at	- 40%

2. Qualifying Payment

The maximum amount that could be claimed as qualifying payment by an individual is to be reduced from the present Rs 150,000/- to Rs 50,000/- from April 1988.

3. Tax Concessions for Housing

(1) From 1st April 1989 the Income from rent of a new house

is to be exempt for 7 years only if the floor area of the house is between 1500 sq.ft and 2000 sq.ft.

(ii) In respect of houses constructed after 1.4.89 investment relief is to be available if the following conditions are satisfied:-

(a) It is the first house constructed after 1st April 1978.

(b) Cost of construction does not exceed 1 million rupees.

(iii) The relief for purchase of a house after 1.4.89 too is to qualify for relief only if the cost of purchase does not exceed 1 million rupees. (Relief

upto Rs 1 million is irrespective of cost of construction or purchase).

- (iv) Construction and sale of Houses and Flats- Sec.21 of the Inland Revenue Act granting exemption from the sale of houses and flats by persons (both individuals and companies) is to be amended to grant a flat exemption of 75% of the profits on the sale. The floor area of 3000 sq. ft is however to be reduced to 2000 sq.ft. This proposal is to be effective from 1.4.88.

4. Imputation System of Taxation for Companies

In future companies will pay only one tax on the profits unlike as at present where they pay a refundable tax and a non-refundable tax. This system of taxation is called the imputation system. The present (existing) system of taxation is known as the classical system. In Sri Lanka, the imputation system of tax on companies was the system from 1932 to 1958. With the introduction of the Kaldor system, the classical system was introduced.

There is economic double taxation under the classical system. Company formation is discouraged. The Budget proposes to introduce a partial imputation system. Individual shareholders in receipt of dividends from companies will receive a 50% imputation tax credit of the tax paid by the company. (For a fuller discussion, see note above).

5. Inter-Company Dividends

Under the present system if a tax holiday company A distributes a dividend to a company B which in turn distributes it to company C and C in turn distributes it to an individual shareholder, the dividend is not exempt in the hands of the shareholder. This is an anomaly. The law is to be amended granting exemption right down the line

6. Withdrawal of Investment Relief

Under Section 31(7) of the Inland Revenue Act, if there is a change of

ownership of shares in respect of which relief has been obtained within 5 years of the date of investment, additional assessments will be issued by the withdrawal of the relief. The section is to be amended as follows:—

Where only part of the investment is withdrawn then only a proportionate part of the tax relief granted will be withdrawn and not the entire relief.

7. Tax Incentives for Export Industries

(a) A "Transferable Tax Credit" scheme, T.T.C. as it is called, is to be introduced to replace the present tax holidays and export grants available to exporters. Actual implementation is still being studied and this is to be implemented later after a Committee appointed by the Minister prepares a report.

(b) Definition of the term 'export turnover' in the Inland Revenue Act to be amended to include sales of raw materials and intermediate goods to G.C.E.C. enterprises provided payment is made from monies drawn from F.C. B.U. i.e. payments in foreign exchange

8. Capital Gains

The period of ownership of gifted or inherited property is to be calculated from the date of the gift or from the date of inheritance and not from 1st April 1977.

9. Depreciation

Under the present law, depreciation is granted on the difference between the purchase price of the new asset and sale price of the old asset. This is to be amended to grant depreciation on the difference between purchase price of the new asset and the profit on sale of the old asset. This is to be effective on sales after 1.4.88.

10. Taxation of Provident Funds and Terminal Benefits

(a) At present, there is a 20% tax on the investment income of provident funds excluding the income from government Securities. A member of the fund is liable on the income he receives as terminal benefits at retire-

ment. This is to be amended as follows:—

From the terminal benefits received by a member will be excluded the portion attributable as represents the investment income which has already been taxed.

(b) Receipts from ETF (Employers Trust Fund) also will be liable to the concessionary rates of tax.

11. Non-Resident Status of Individuals

The basis of determining non-resident status of an individual as contained in Section 67 of the Inland Revenue Act is to be amended.

The amendments contemplated are as follows:—

(a) A period or periods aggregating not more than 30 days in a year is ignored in determining non-resident status.

(b) An individual who became non-resident could become a resident if he or she spends an aggregate of more than 183 days in Sri Lanka during that year of assessment. (Assessment is not from date of arrival but year of assessment).

12. Time Bar for Assessment

There is a 3 year period for time bar if a person furnishes the return before 30th November. If he fails to furnish by that date, there is no time bar under the present law. This is to be amended as follows:—

If the person furnishes the return between 30th November and 31st March of the following year, the time bar is 5 years and not indefinite.

13. Accounting Year

Certain persons are allowed by the Commissioner-General of Inland Revenue to keep their accounts to a date other than the 31st March under Section 25 (3) of the Act. These persons however under the present law pay taxes on their income from 1st April to 31st March. This is to be amended by making those persons pay the tax also on the profits of the accounting year.

14. Turnover Tax

The changes in the Turnover Tax would include:

1. Reduction in the rate from 3% to 1% of certain items.
2. Turnover tax on Transport Services reduced from 3% to 1%.
3. A licensing fee of Rs 1 million is payable by operators of Casinos and Rs 100,000 is payable by bookmakers. (This is alternate to BTT).
4. Rate of turnover tax on Investment Companies reduced from 5% to 1%.
5. Beedi Manufacturers - Rate of tax is 3%.
6. Business of Buying and Selling Furniture and Timber—
 - (a) Both on the manufacture of buying and selling of furniture and the business of buying
 - (a) Both on the manufacture of furniture and the business of buying and selling of furniture the rate is 5%.
 - (b) Similarly on the sale of timber whether in the sawn or log form, the rate is 5%.
7. Turnover Tax exemption on sales to Exporters - Sale of raw materials to exporters will be exempt from turnover tax. Under the present system the supplier has to claim a refund and this takes time. (Unless specified this concession can be abused an Exporters Certificate is required).