CHAPTER IV

ASSETS AND LIABILITIES

Division I: Calculation of Gains and Losses

Calculating gains and losses.

36. (1) A person's gain from the realisation of an asset or liability shall be the amount by which the sum of the consideration received for the asset or liability exceeds the cost of the asset or liability at the time of realisation.

(2) The loss of a person from the realisation of an asset or liability shall be the amount by which the cost of the asset or liability exceeds the sum of the consideration received for the asset or liability at the time of realisation.

(3) A gain made by a person on the realisation of an investment asset shall be reduced by any part of the gain that is included in calculating the person's income from an employment or business.

(4) Where an asset or liability owned by a person is used in the production of two or more sources of income, the cost of and consideration received for the asset shall be apportioned between each source according to the market value of the parts used to produce each source.

Cost of an asset.

37. (1) Subject to this Act, the cost of an asset of a person shall be the sum of –

(*a*) expenditure incurred by the person in acquiring the asset including, where relevant, expenditure on construction, manufacture or production of the asset;

(*b*) expenditure incurred by the person in altering, improving, maintaining or repairing the asset;

(*c*) incidental expenditure incurred by the person in acquiring and realising the asset; and (*d*) income amounts referred to in subsection (2).

(2) An income amount shall be –

(*a*) an amount required by Division II of Chapter II to be directly included in calculating the person's income or that is an exempt amount or final withholding payment of the person;

(*b*) where the treatment in paragraph (*a*) results from the person acquiring the asset or another person incurring expenditure of the type mentioned in paragraph (*b*) or (*c*) of subsection (1) on behalf of the person.

(3) The cost of an asset shall not include consumption expenditure, excluded expenditure and expenditure to the extent to which it is deducted in calculating a person's income or included in the cost of another asset.

(4) In this section, "incidental expenditure" incurred by a person in acquiring or realising an asset shall include –

(*a*) advertising expenditure, transfer taxes, duties and other expenditure of transfer;

(*b*) expenditure of establishing, preserving or defending ownership of the asset; and

(*c*) remuneration for the services of an accountant, agent, auctioneer, broker, consultant, legal advisor, surveyor or valuer relating to expenditure referred to in paragraph (*a*) or (*b*).

Consideration received.

38. (1) Subject to this Act, consideration received for an asset of a person at a particular time shall be –

(*a*) amounts received or receivable by the person for the asset, including the fair market value of any consideration in kind determined at the time of realisation;

(*b*) amounts derived by the person in respect of owning the asset including –

(i) amounts derived from altering or decreasing the value of the asset; and

(ii) amounts derived from the asset including by way of covenant to repair or otherwise; and

(*c*) amounts derived by the person or an entitlement for the person to derive an amount in the future in respect of realising the asset.

(2) The consideration received for the realisation of an asset shall include the consideration for the grant of an option in relation to the asset, only if the person has not been subject to tax in respect of any income or gain made on the grant of the option.

(3) The consideration received for an asset shall not include an exempt amount, a final withholding payment or, other than in the case of trading stock, an amount to be directly included in calculating the person's income under Division II of Chapter II.

Realisation.

39. Subject to this Act, a person who owns an asset shall be treated as realising the asset –

(*a*) when that person parts with ownership of the asset, including when the asset is sold, exchanged, transferred, distributed, cancelled, redeemed, destroyed, lost, expired, expropriated or surrendered;

(*b*) in the case of an asset of a person who ceases to exist, including by reason of the death of an individual, immediately before the person ceases to exist;

(*c*) in the case of an asset other than trading stock or a depreciable asset, where the sum of consideration received from owning the asset exceeds the cost of the asset;

(*d*) in the case of an asset that is a debt claim owned by a person, the person reasonably believes the debt claim will not be satisfied, where the person has taken reasonable steps in pursuing the debt claim and the person writes the debt off as bad;

(*e*) in the case of trading stock, a depreciable asset, a capital asset of a business or an investment asset, immediately before the person begins to employ the asset in such a way that it ceases to be an asset of any of those types; and

(*f*) in the circumstances referred to in section 70 (change of residence).

Liabilities.

40. (1) The costs of and consideration received for a liability of a person shall be determined in accordance with sections 37 and 38 as though –

(*a*) a reference to an asset were a reference to a liability;

(*b*) expenditure incurred in realising the liability is included in the costs of the liability; and

(*c*) amounts derived in respect of incurring the liability are included in the consideration received for the liability.

(2) Subject to this Act, a person who owes a liability shall be treated as realising the liability –

(*a*) when the person ceases to owe the liability, including when the liability is transferred, satisfied, cancelled, released or expired;

(*b*) in the case of a liability of a person who ceases to exist, including by reason of the death of an individual, immediately before the person ceases to exist; and

(*c*) in the circumstances referred to in section 70 (change of residence).

(3) Subject to any regulations, the provisions of Division II shall apply, with any necessary adaptations, to liabilities in a manner similar to that in which they apply to assets.

Reversal, quantification and compensation of amounts.

41. (1) Subject to section 24, where a person includes expenditure in the cost of an asset or liability and later recovers the expenditure, the person shall include the amount recovered in the consideration received for the asset or liability, as the case requires.

(2) Subject to section 24 where a person includes an amount derived as consideration received for an asset or liability and, later refunds the amount, the person may include the amount refunded in the cost of the asset.

(3) Where a person or an associate of a person derives an amount which compensates for or represents –

(*a*) recovery of actual or expected costs or expected but not received consideration for an asset or liability; or

(*b*) a loss in value of an asset or increase in a liability,

subject to any other adjustment made under this Act, the compensation amount shall be included in the consideration received for the asset or liability, as the case requires.

Division II: Realisation of assets

Cost of trading stock and other fungible assets.

42. (1) For the purposes of determining the cost of trading stock of a business of a person –

(*a*) no amount shall be included in respect of the repair, improvement or depreciation of depreciable assets; and

(*b*) subject to the provisions of paragraph (*a*), the absorption-cost method shall be used for amounts that are eligible to be included in the cost of the trading stock (section 37).

(2) The owner of an asset referred to in subsection (3) may elect for the cost of the asset to be determined according to the first-in-first-out method or the average-cost method. Once chosen, the method shall only be changed with the written permission of the Commissioner-General.

(3) The assets referred to in subsection (2) shall be trading stock or any other type of asset specified by the Commissioner-General that are fungible and not readily identifiable.

(4) In this section –

"absorption-cost method" means the generally accepted accounting principle under which the cost of trading stock is the sum of direct asset costs, direct labour costs and factory overhead costs;

"average-cost method" means the generally accepted accounting principle under which costs are allocated to fungible assets of a particular type owned by a person based on a weighted average cost of all assets of that type owned by the person;

"direct labour costs" means expenditure incurred by a person on labour that directly relates to the production of trading stock;

"direct asset costs" means expenditure incurred by a person in acquiring any asset or assets that constitutes trading stock or becomes an integral part of trading stock produced;

"factory overhead costs" means all expenditure incurred by a person in producing trading stock except direct labour and direct asset costs; and

"first-in-first-out method" means the generally accepted accounting principle under which costs are allocated to a fungible asset of a particular type owned by a person based on the assumption that assets of that type owned by the person are realised in the order of their acquisition.

Realisation with retention of asset.

43. Where a person realises an asset in any of the manners set out in paragraphs (*c*) to (*f*) of section 39 –

(*a*) the person shall be treated as having parted with ownership of the asset and deriving an amount in respect of the realisation equal to the market value of the asset at the time of the realisation; and

(*b*) the person shall be treated as reacquiring the asset and incurring expenditure of the amount referred to in paragraph (*a*) in the acquisition.

Transfer of asset to spouse or former spouse.

44. Where on death or as part of a divorce settlement or *bona fide* separation agreement an individual transfers, an asset to a spouse or former spouse and an election for this section to apply is made by the spouse or former spouse in writing –

(*a*) the individual shall be treated as deriving an amount in respect of the realisation equal to the net cost of the asset immediately before the realisation; and (*b*) the spouse or former spouse shall be treated as incurring expenditure of the amount referred to in paragraph (*a*) in acquiring the asset.

Transfer of asset on death.

45. Where an individual realises an asset on death by way of transfer of ownership of the asset to another person –

(*a*) the individual shall be treated as deriving an amount in respect of the realisation equal to the net cost of the asset at the time of realisation; and

(*b*) the person who acquires ownership of the asset shall be treated as incurring expenditure of the amount referred to in paragraph (*a*) in the acquisition.

Transfer of asset to an associate or for no consideration.

46. (1) Subject to this section and sections 44 and 45, where a person realises an asset by way of transfer of ownership of the asset to an associate of the person or by way of transfer to any other person by way of gift –

(*a*) the person shall be treated as deriving an amount in respect of the realisation equal to the greater of the market value of the asset or the net cost of the asset immediately before the realisation; and

(*b*) the person who acquires ownership of the asset shall be treated as incurring expenditure of the amount referred to in paragraph (*a*) in the acquisition.

(2) Where an individual realises an asset by way of transfer of ownership of the asset to an associate of the individual or a charitibale institution and the requirements of subsection (3) are met –

(*a*) the individual shall be treated as deriving an amount in respect of the realisation equal to the net cost of the asset immediately before the realisation; and

(*b*) the associate or the charitable institution shall be treated as incurring expenditure of the amount referred to in paragraph (*a*) in acquiring the asset.

(3) The requirements specified in subsection (2) shall be–

(*a*) in the case of a transfer to an associate–

(i) the associate in relation to the individual is the individual's child by marriage or adoption, spouse, parent, grandparent, grandchild, sibling, aunt, uncle, nephew, niece or first cousin; and

(ii) the asset is an interest in land or a building situated in Sri Lanka; or

(*b*) in the case of a transfer to a charitable institution, the transfer occurs by way of gift.

(4) Where a person realises an asset, being trading stock, a depreciable asset, an investment asset or a capital asset of a business, by way of transfer of ownership of the asset to an associate of the person and the requirements of subsection (5) are met –

(*a*) the person shall be treated as deriving an amount in respect of the realisation equal to the net cost of the asset immediately before the realisation; and

(*b*) the associate shall be treated as incurring expenditure of the amount referred to in paragraph (*a*) in acquiring the asset.

(5) The requirements specified in subsection (4) are –

(*a*) the person or the associate is an entity;

(*b*) the asset or assets are trading stock, depreciable assets, investment assets or capital assets of a business of the associate immediately after transfer by the person;

(*c*) at the time of the transfer –

(i) the person and the associate are residents; and

(ii) the associate or, in the case of an associate partnership, none of its partners is exempt from income tax; and

(*d*) there is continuity of underlying ownership in the asset of at least fifty *per cent.*

Involuntary realisation of asset with replacement.

47. (1) Where a person involuntarily realises an asset in any manner set out in paragraph (*a*) of section 39 and acquires a replacement asset of the same type within six months before or within one year after the realisation and elects in writing for this subsection to apply, that person shall be treated as –

(*a*) deriving an amount in respect of the realisation equal to the aggregate of –

(i) the net cost of the asset immediately before the realisation; and

(ii) the amount, if any, by which amounts derived in respect of the realisation exceed expenditure incurred in acquiring the replacement asset; and

(*b*) incurring expenditure in acquiring the replacement asset equal to the aggregate of –

(i) the amount referred to in paragraph (*a*)(i); and

(ii) the amount, if any, by which expenditure incurred in acquiring the replacement asset exceeds amounts derived in respect of the realisation.

(2) The Commissioner-General may specify the circumstances in which the replacement of one security in a company with another security in the same company or a different company (including as a result of merger, demerger or reconstruction) constitutes an involuntary realisation.

Realisation by separation.

48. (1) Subject to section 49 where rights or obligations with respect to an asset owned by one person are assigned to another person, including by way of lease of an asset or part thereof, then –

(*a*) where the rights or obligations are permanent, the one person shall be treated as realising part of the asset, but shall not be treated as acquiring any new asset or liability; and

(*b*) where the rights or obligations are temporary or contingent, the person shall not be treated as realising part of the asset or liability, but as acquiring a new asset or incurring a new liability, as the case requires.

(2) Rights or obligations shall be considered permanent when they are likely to last for more than fifty years.

Transfer by way of security, finance lease or instalment sale.

49. (1) Where a person grants a mortgage (legal or equitable) or similar form of security over an asset to secure a debt owed to another person –

(*a*) the first person shall not be treated as realising the asset or any part of it, but shall be treated as still owning the asset and as having incurred a liability being the secured debt; and

(*b*) the other person shall not be treated as acquiring the asset or any part of it, but shall be treated only as owning the secured debt.

(2) Where an asset is leased under a finance lease, the lessor shall be treated as transferring ownership of the asset to the lessee.

(3) Subject to section 46 where a person transfers an asset under an instalment sale or, under a finance lease under subsection (2) –

(*a*) the person shall be treated as deriving an amount in respect of the transfer equal to the market value of the asset immediately before the transfer; and

(*b*) the person who acquires the asset shall be treated as incurring expenditure of the amount referred to in paragraph (*a*) in acquiring the asset.

(4) Where a lessee under a finance lease returns the asset to the lessor before ownership passes to the lessee (except the transaction referred to in subsection (2)) the lessee shall be treated as transferring ownership of the asset back to the lessor.

(5) In this section, "finance lease" and "instalment sale" shall have the same meaning as in section 31.

Payment of tax on gains from realisation of an asset.

50. The manner and the procedure relating to the payment of tax on the gain from realisation of an asset may be specified by the Commissioner- General.

Apportionment of costs and consideration received.

51. (1) Where a person acquires one or more assets by way of transfer at the same time or as part of the same arrangement, the expenditure incurred in acquiring each asset shall be apportioned between the assets according to their market values at the time of acquisition.

(2) Where a person realises one or more assets by way of transfer at the same time or as part of the same arrangement, the amounts derived in realising each asset shall be apportioned between the assets according to their market values at the time of realisation.

(3) Where a person who owns an asset realises part of it, the net cost of the asset immediately before the realisation

shall be apportioned between the part of the asset realised and the part retained according to their market values immediately after the realisation.

CHAPTER V

TYPES OF PERSONS

Division I: Individuals and Entities

Qualifying payments and reliefs.

52. (1) In arriving at the taxable income of an individual or entity for a year of assessment under section 3, the aggregate qualifying payments referred to in the Fifth Schedule to this Act shall be deducted.

(2) In arriving at the taxable income of an individual who is resident in Sri Lanka for a year of assessment under section 3, the aggregate reliefs referred to in the Fifth Schedule to this Act shall be deducted.

(3) In arriving at the taxable income of an individual who is not resident in Sri Lanka for a year of assessment but is a citizen of Sri Lanka under section 3, the relief referred to in paragraph 2(*a*) of the Fifth Schedule to this Act shall be deducted.

Division II: Partnerships

Partnerships.

53. (1) Subject to subsection (2), a partnership shall not be liable to pay income tax with respect to its taxable income and shall not be entitled to any tax credit with respect to that income, but shall be liable to pay income tax with respect to withholding payments.

(2) The provisions of subsection (1) shall not apply to a partnership to the extent that the partnership's taxable income includes a gain from the realisation of an investment asset.