

calculating income from an investment and unrelieved losses from an investment so that –

- (a) unrelieved losses from a business may be deducted in calculating income from an investment;
- (b) unrelieved losses from an investment shall be deducted only in calculating income from an investment.

(5) Subject to section 194, a gain from the realisation of an investment asset shall not be reduced by any loss on the disposal of another investment asset.

(6) In this section –

“loss” of a person for a year of assessment from a business or investment shall be calculated as the excess of amounts deducted in accordance with this Act (other than under this section or subsection (5) of section 25) in calculating the person’s income from the business or investment over amounts included in calculating that income; and

“unrelieved loss” means the amount of a loss that has not been deducted in calculating a person’s income under this section or subsection (5) of section 25.

CHAPTER III

CALCULATION OF THE INCOME TAX

Division 1: Method of Accounting

Change in the year of assessment.

20. (1) The year of assessment means the period of twelve months commencing on the first day of April of any year and ending on the thirty first day of March in the immediately succeeding year.

(2) A trust or company may apply to the Commissioner-General for a change to its year of assessment and the Commissioner-General may, on such terms and conditions as the Commissioner-General thinks fit, approve the change. The Commissioner-General may revoke an approval if a trust or company fails to comply with a term or condition attached to the approval.

(3) A change in a trust or company's year of assessment shall result in altering the time at which the trust or company shall pay tax by instalments and on assessment under Chapter VIII.

21. (1) Unless otherwise provided by this Act, the timing of inclusions and deductions in calculating a person's income shall be made according to generally accepted accounting principles.

Method of accounting.

(2) An individual shall account for income tax purposes on a cash basis in calculating the individual's income from an employment or investment.

(3) An individual or entity conducting business shall account for income tax purposes on an accrual basis.

(4) A person shall account for income tax purposes the income from sources other than the sources referred to in subsections (2) and (3) on either a cash or accrual basis, whichever properly computes the person's income.

(5) Subject to subsections (2) and (3), the Commissioner-General may by written notice require a person to use a particular method of accounting or may approve an application of a person to change the person's method of accounting. The Commissioner-General shall be satisfied that the new method is necessary to properly compute the person's income.

(6) Where a person's method of accounting changes, adjustments shall be made in the year of assessment following

the change so that no item is omitted or taken into account more than once.

Cash basis
accounting.

22. (1) Under the cash basis of accounting, a person –

- (a) derives an amount when payment is received by or made available to the person; and
- (b) incurs an expense or other amount when it is paid by the person.

(2) For the purpose of this section, payment received in relation to an amount shall include –

- (a) used on behalf of the person either at the instruction of the person or under any law;
- (b) reinvested, accumulated or capitalised for the benefit of the person;
- (c) credited to an account, or carried to any reserve, or a sinking or insurance fund for the benefit of the person; or
- (d) constructive receipt.

Accrual basis
accounting.

23. (1) Under the accrual basis of accounting, a person –

- (a) derives an amount when it is receivable by the person; and
- (b) incurs an expense or other amount when it is payable by the person.

(2) An amount shall be receivable by a person when the person becomes entitled to receive it, even if the time for discharge of the entitlement is postponed or the entitlement is payable by instalments.

(3) An amount shall be treated as payable by the person when all the events that determine liability have occurred and the amount of the liability can be determined with reasonable accuracy, but not before economic performance with respect to the amount occurs.

(4) For the purposes of subsection (3), economic performance occurs –

- (a) with respect to the acquisition of services or assets, at the time the services or assets are provided;
- (b) with respect to the use of an asset, at the time the asset is used; and
- (c) in any other case, at the time the person makes payment in full satisfaction of the liability.

(5) Where in calculating income on an accrual basis an inaccuracy referred to in subsection (6) or (7) occurs –

- (a) appropriate adjustments shall be made at the time the payment is received or made to remedy the inaccuracy, or at the time of the deemed inaccuracy; and
- (b) the Commissioner-General may require the person to include the appropriate adjustment in the year of assessment in which the inaccuracy originally occurred notwithstanding the time limits specified in Part II of this Act for the amendment of assessments.

(6) An inaccuracy occurs –

- (a) when a person is calculating for a payment of a particular quantity to which the person is entitled or that the person is obliged to make; and

- (b) subsequently that entitlement or obligation being satisfied by a payment received or made by the person, as the case requires, of a different amount, including by reason of a change in currency valuations.

(7) An inaccuracy is deemed to occur when –

- (a) a person is calculating for a payment of a particular quantity that the person is obliged to make; and
- (b) subsequently that obligation is not satisfied by a payment being made by the person within three years of the obligation arising.

Reverse of
amounts
including bad
debts.

24. (1) Where a person deducts an expense in calculating the person's income and the person later recovers the expense, the person shall, at the time of recovery, include the amount recovered in calculating the person's income.

(2) Where a person includes an amount in calculating the person's income, because of a legal obligation to do so, and the person later refunds the amount, the person shall, at the time of refund, shall deduct the amount refunded in calculating the person's income.

(3) Where, in calculating income on an accrual basis, a person deducts an expense that the person is obliged to make and the person later disclaims an obligation to incur the expense, the person shall, at the time of disclaimer, include the amount disclaimed in calculating the person's income.

(4) Subsection (5) shall be applicable where, in calculating income on an accrual basis, a person includes an amount to which the person is entitled and the person later –

- (a) disclaims an entitlement to receive the amount; or

- (b) in the case where the amount constitutes a debt claim of the person, the person writes off the debt as bad.

(5) Subject to the provisions of subsection (6), the person may, at the time of disclaimer or write off, deduct the amount disclaimed or written off in calculating the person's income.

(6) Subject to section 66 (banking business activities), a person cannot disclaim the entitlement to receive an amount or write off a debt claim as bad unless the person has taken reasonable steps in pursuing payment and the person reasonably believes that the entitlement or debt claim will not be satisfied.

Division II: Long Term Contracts

25. (1) This section shall apply to a person who conducts a business, accounts for income tax purposes on an accrual basis with respect to that business and is a party to a long-term contract.

Long-term contracts.

(2) Amounts to be included or deducted in calculating the person's income that relate to a long-term contract shall be taken into account on the basis of the percentage of the contract completed during each year of assessment.

(3) The percentage of completion shall be determined by comparing the total expenses allocated to the contract and incurred before the end of a year of assessment with the estimated total contract expenses as determined at the time of commencement of the contract.

(4) Subsection (5) shall apply where a long-term contract is completed and the person has an unrelieved loss attributable to that contract for the year of assessment in which the contract ended or any earlier year of assessment. An unrelieved loss of a business for a year of assessment shall be attributable to a long-term contract to the extent that there is a loss from the contract for the year.

(5) The Commissioner-General may allow the unrelieved loss to be carried back and treated as an unrelieved loss of an earlier year of assessment for the purpose of section 19. The amount carried back shall be limited to the profit, if any, from the contract for the year of assessment to which the loss is carried back.

(6) A profit or a loss from a long-term contract for a year of assessment shall be determined by comparing amounts included in income under the contract with deductions under the contract for that year.

(7) In this section –

“long-term contract” means a contract –

- (a) for manufacture, installation or construction or, in relation to each, the performance of related services; and
- (b) which is not completed within twelve months of the date on which work under the contract commences.

“unrelieved loss”, with respect to a business, shall have the meaning given in section 19.

Foreign
currency and
financial
instruments.

26. (1) Subject to subsections (4) and (5), this section shall apply to a person who is a financial institution where, under the provisions in Division II or IV of Chapter II, that person shall include an amount or may deduct an amount in relation to a financial instrument in calculating income from a business or investment.

(2) The time at which the amount is to be included or deducted shall be determined in accordance with generally accepted accounting principles. Those principles also determine to whom the amount shall be allocated, its quantum and its character.

(3) In particular, generally accepted accounting principles apply even if they require the inclusion or deduction of an amount on a fair value accounting (mark-to-market) basis irrespective of –

- (a) the other provisions of this Division;
- (b) whether or not the amounts have yet been derived, incurred or realised; and
- (c) whether or not the amounts are of a capital or revenue nature.

(4) With the prior written approval of the Commissioner-General a person may include an amount or deduct an amount in relation to a financial instrument in calculating income from a business or investment –

- (a) when realised;
- (b) using a specified treatment relating to the character and timing of the amount, including where the financial instrument has been entered into for hedging purposes; and
- (c) where the amount is in a currency other than Sri Lankan Rupees, using a specified translation method such as requiring that the amount must be translated to Sri Lankan Rupees at the exchange rate applying between the foreign currency and Sri Lankan Rupees on the date the amount is taken into account for the purposes of this Act.

(5) The Commissioner-General may specify the extent to which this section applies to another person or class of persons.

(6) In the absence of an applicable specification by the Commissioner-General under subsection (5), an amount taken

into account under this Act shall be expressed in Sri Lankan Rupees and, if an amount is in a currency other than Sri Lankan Rupees, the amount shall be translated to Sri Lankan Rupees at the Central Bank of Sri Lanka exchange rate applying between the foreign currency and Sri Lankan Rupees on the date the amount is taken into account for the purposes of this Act.

Quantifying a payment or amount.

27. (1) A payment or amount to be included or deducted in calculating income of a person shall be quantified in the amount, as specified by the Commissioner-General or, in any other case, according to market value.

(2) The amount of a payment shall be quantified without reduction for any tax withheld from the payment under Division II of Chapter VIII of this Act.

(3) Market value shall be determined –

- (a) with due regard for the arm's length standard referred to in section 33; but
- (b) in the case of an asset, without regard to any restriction on transfer of the asset or the fact that the asset is not otherwise convertible into a payment of money or money's worth.

Indirect payments.

28. (1) Subsection (2) shall apply where a person may indirectly benefit from a payment or direct who is to be the payee of a payment and the payer intends the payment to benefit the person.

(2) The Commissioner-General may, by notice in writing served on the person –

- (a) treat a person as the payee of the payment;
- (b) treat a person as the payer of the payment; or

- (c) treat the person as the payee of the payment and as making an equal payment to the person who would be considered the payee of the payment.

(3) In this section, an intention of the payer of a payment includes an intention of an associate of the payer or a third person under an arrangement with the payer or with an associate of the payer.

29. (1) In calculating a person's income from an investment that is jointly owned with another person, amounts to be included and deducted shall be apportioned among the joint owners in proportion to their interests in the investment. Jointly owned investments.

(2) Where the interests of joint owners cannot be ascertained they shall be treated as equal.

30. Where a person or an associate of the person derives an amount which compensates for or represents recovery of – Compensation and recovery payments.

- (a) income or an amount to be included in calculating income, which the person expects or expected to derive; or
- (b) a loss or an amount to be deducted in calculating income, which the person has incurred or which the person expects or is expected to incur,

subject to section 24, the compensation amount shall be included in calculating the income of the person and takes its character from the amount compensated for.

31. (1) Payments made by a person under a finance lease or in acquiring an asset under an instalment sale shall be treated as interest and a repayment of capital under a loan made by the lessor or seller to the lessee or buyer, as the case requires. Annuities, instalment sales and finance leases.

(2) Payments made to a person under an annuity shall be treated as interest and a repayment of capital under a loan made by the person to the payer of the annuity.

(3) The interest and repayment of capital under subsections (1) and (2) shall be calculated as if the loan were a blended loan with interest compounded six-monthly or such other period as the Commissioner-General may specify.

(4) Section 49 provides further provisions regarding transfers under finance leases and instalment sales.

(5) The Commissioner-General may specify any other forms of financing that relates to interest substitutes.

(6) For the purposes of this section –

“annuity” does not include an amount payable –

- (a) under an order of court by way of payment of alimony or maintenance; or
- (b) to a spouse under a duly executed deed of separation;

“blended loan” means a loan –

- (a) under which payments by the borrower represent in part a payment of interest and in part a repayment of capital;
- (b) where the interest part is calculated on capital outstanding at the time of each payment; and
- (c) where the rate of interest is uniform over the term of the loan;

“finance lease” means a lease where –

- (a) the lease agreement provides for transfer of ownership following the end of the lease term or the lessee has an option to acquire the asset after expiry of the lease term for a fixed or presupposed price;

- (b) the lease term exceeds seventy five *per cent* of the useful life of the asset;
- (c) the estimated market value of the asset after expiry of the lease term is less than twenty *per cent* of its market value at the start of the lease;
- (d) in the case of a lease that commences before the last twenty five percent of the useful life of the asset, the present value of the minimum lease payments equals or exceeds ninety *per cent* of the market value of the asset at the start of the lease term; or
- (e) the asset is custom-made for the lessee and after expiry of the lease term the asset will not be of practical use to any person other than the lessee;

“instalment sale” excludes a sale that provides for commercial periodic interest payable on sales proceeds outstanding; and

“lease term” includes an additional period for which the lessee has an option to renew a lease.

32. Income arising from any Islamic financial transaction shall be subject to tax in a similar manner as equivalent in substance to non-Islamic financial transactions.

Islamic financial transactions.

33. (1) Where an arrangement exists between associated persons, the persons shall calculate their income and tax payable according to the arm’s length standard.

Arm’s length standard and arrangements between associates.

(2) The arm’s length standard requires associated persons to quantify, characterise, apportion and allocate amounts to be included or deducted in calculating income to reflect arrangements that would have been made between independent persons.

(3) The Commissioner-General may by publication in the *Gazette* specify the manner in which arm's length agreements may be entered into for the purpose of determining the arm's length price.

(4) Where, in the opinion of the Commissioner-General, a person fails to comply with subsection (1), the Commissioner-General may make adjustments in compliance with subsection (1) and the Commissioner-General may –

- (a) re-characterise an arrangement made between associated persons, including re-characterising debt financing as equity financing;
- (b) re-characterise the source and type of any income, loss, amount or payment; and
- (c) apportion and allocate expenditure, based on turnover.

Income splitting.

34. (1) Where a person attempts to split income with another person, the Commissioner-General may prevent any reduction in tax payable by issuing a notice in writing.

(2) A notice referred to in subsection (1) may contain amounts to be included or deducted in calculating the income of each person or re-characterise the source and type of any income, loss, amount or payment.

(3) A reference to a person attempting to split income includes a reference to an arrangement between associated persons –

- (a) for the transfer of an asset (directly or indirectly), including the transfer of an amount to be derived;
- (b) where the transferor retains any legal or implicit right to benefit (currently or in the future) from the asset; and

- (c) where one of the reasons for the transfer is to lower tax payable by any person.

(4) Where a spouse receives income for services rendered in any business carried on or exercised –

- (a) by the other spouse; or
- (b) by a partnership of which that other spouse is a partner,

the income shall be included in the income of the spouse who carries on the business or that partnership of which that other spouse is a partner.

35. (1) This section shall apply where the Commissioner-General is satisfied that –

Tax avoidance schemes.

- (a) a scheme has been entered into or carried out;
- (b) a person has obtained a tax benefit in connection with the scheme; and
- (c) having regard to the substance of the scheme, it can be concluded that a person, or one of the persons, who entered into or carried out the scheme did so for the sole or dominant purpose of enabling the person referred to in paragraph (b) to obtain a tax benefit.

(2) Notwithstanding anything in this Act, the Commissioner-General may determine the tax liability of the person who obtained the tax benefit as if the scheme had not been entered into or carried out, or as if a reasonable alternative to entering into or carrying out the scheme would have instead been entered into or carried out, or that any transaction which reduces or would have the effect of

reducing the amount of tax payable by any person is artificial or fictitious and can make compensating adjustments to the tax liability of any other person affected by the scheme.

(3) Where a determination or adjustment is made, the Commissioner-General shall issue an assessment giving effect to the determination or adjustment.

(4) The assessment made under subsection (3) shall be served within five years from the last day of the year of assessment to which the determination or adjustment relates.

(5) For the purposes of this section -

“scheme” includes any course of action, trust, grant, agreement, arrangement, understanding, promise, plan, proposal or undertaking, whether express or implied and whether or not enforceable;

“tax benefit” means –

- (a) a reduction in a liability to pay tax, including on account of a deduction, credit, offset or rebate;
- (b) a postponement of a liability to pay tax;
- (c) any other advantage arising because of a delay in payment of tax; or
- (d) anything that causes –
 - (i) an amount of gross revenue to be exempt income or otherwise not subject to tax; or
 - (ii) an amount that would otherwise be subject to tax not to be taxed.

CHAPTER IV

ASSETS AND LIABILITIES

Division I: Calculation of 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.

Calculating
gains and losses.

(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.

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

Cost of an asset.

- (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