(*c*) deducting any other tax credit granted or allowed to the person for the year under this Act.

(4) The income tax payable by a person under paragraph (*b*) of subsection (1) shall be calculated by applying the relevant rate set out in the First Schedule to this Act to each final withholding payment.

CHAPTER II

INCOME TAX BASE

Division I: Taxable Income

Taxable income.

3. (1) Subject to subsection (2), the taxable income of a person for a year of assessment shall be equal to the total of the person's assessable income for the year from each employment, business, investment and other sources.

(2) In arriving at taxable income of a year of assessment qualifying payments and reliefs for that year under section 52 shall be deducted.

(3) The taxable income of each person and the assessable income from each source shall be determined separately.

Division II: Assessable Income

Assessable income.

4. The assessable income of a person for a year of assessment from employment, business, investment or other source shall be equal to –

(*a*) in the case of a resident person, the person's income from employment, business, investment or other source for that year, wherever the source arises**;** and

(*b*) in the case of a non-resident person, the person's income from the employment, business, investment or other source for that year, to the extent that the income arises in or is derived from a source in Sri Lanka.

Employment income.

5. (1) An individual's income from an employment for a year of assessment shall be the individual's gains and profits from the employment for that year of assessment.

(2) In calculating an individual's gains and profits from an employment for a year of assessment the following amounts received or derived by the individual during the year of assessment from the employment shall be included:-

(*a*) payments of salary, wages, leave pay, overtime pay, fees, pensions, commissions, gratuities, bonuses and other similar payments;

(*b*) payments of personal allowance, including any cost of living, subsistence, rent, entertainment or travel allowance;

(*c*) payments providing discharge or reimbursement of expenses incurred by the individual or an associate of the individual;

(*d*) payments for the individual's agreement to conditions of employment;

(*e*) payments for redundancy or loss or termination of employment;

(*f*) subject to paragraph (*f*) of subsection (3), retirement contributions made to a retirement fund on behalf of the employee and retirement payments received in respect of the employment;

(*g*) payments or transfers to another person for the benefit of the individual or an associate person of the individual;

(*h*) the fair market value of benefits received or derived by virtue of the employment by an individual or an associate person of the individual;

(*i*) other payments, including gifts received in respect of the employment; and

(*j*) the market value of shares at the time allotted under an employee share scheme, including shares allotted as a result of the exercise of an option or right to acquire the shares, reduced by the employee's contribution for the shares.

(3) In calculating an individual's gains and profits from an employment for a year of assessment the following shall be excluded:-

(*a*) exempt amounts and final withholding payments;

(*b*) a discharge or reimbursement of expenses incurred by the individual on behalf of the employer;

(*c*) a discharge or reimbursement of the person's dental, medical or health insurance expenses where the benefit is available to all full-time employees on equal terms;

(*d*) payments made to or benefits accruing to employees on a non-discriminatory basis that, by reason of their size, type and frequency, are unreasonable or administratively impracticable for the employer to account for or to allocate to the individual;

(*e*) the value of a right or option to acquire shares at the time granted to an employee under an employee share scheme (referred to in paragraph (*j*) of subsection (2)); and (*f*) subject to conditions as may be specified by the Commissioner-General, contributions made by an employer to an employee's account with a pension, provident or savings fund or savings society approved by the Commissioner - General.

Business income.

6. (1) A person's income from a business for a year of assessment shall be the person's gains and profits from conducting the business for the year.

(2) In calculating a person's gains and profits from conducting a business for a year of assessment the following amounts derived by the person during the year of assessment from the business shall be included–

(*a*) service fees;

(*b*) consideration received in respect of trading stock;

(*c*) gains from the realisation of capital assets and liabilities of the business as calculated under Chapter IV;

(*d*) amounts required to be included by the Second or Fourth Schedule to this Act on the realisation of the person's depreciable assets of the business;

(*e*) amounts derived as consideration for accepting a restriction on the capacity to conduct the business;

(*f*) gifts received by the person in respect of the business;

(*g*) amounts derived that are effectively connected with the business and that would otherwise be included in calculating the person's income from an investment; and (*h*) other amounts required to be included under this Act.

(3) In calculating a person's gains and profits from conducting a business for a year of assessment the following shall be excluded:-

(*a*) exempt amounts and final withholding payments; and

(*b*) amounts that are included in calculating the person's income from an employment.

Investment income.

7. (1) A person's income from an investment for a year of assessment shall be the person's gains and profits from that investment for the year.

(2) In calculating a person's gains and profits from an investment derived or received during a year of assessment the following amounts received or derived by the person during the year of assessment from the investment shall be included:-

(*a*) dividends, interest, discounts, charges, annuities, natural resource payments, rents, premiums and royalties;

(*b*) gains from the realisation of investment assets as calculated under Chapter IV;

(*c*) amounts derived as consideration for accepting a restriction on the capacity to conduct the investment;

(*d*) gifts received by the person in respect of the investment;

(*e*) winnings from lotteries, betting or gambling; and

(*f*) other amounts required to be included under this Act.

(3) In calculating a person's gains and profits from an investment for a year of assessment the following shall be excluded:-

(*a*) exempt amounts and final withholding payments; and

(*b*) amounts that are included in calculating the person's income from an employment or business.

Other income.

8. (1) A person's income from other sources for a year of assessment shall be that person's gains and profits from any source whatsoever for the year, not including profits of a casual and non-recurring nature.

(2) In calculating a person's gains or profits from any source whatsoever, the following shall be excluded:-

(*a*) exempt amounts and final withholding payments; and

(*b*) amounts that are included in calculating the person's income from an employment, business or investment.

Division III: Exempt Amounts

Exempt amounts.

9. (1) The amounts referred to in the Third Schedule to this Act shall be exempt from the payment of tax.

(2) Notwithstanding any law to the contrary, an exemption of any person or amount from tax imposed by this Act shall not be provided and an agreement that affects or purports to affect the application of this Act shall not be entered into, except as provided for in this Act.

(3) Subsection (2) shall not apply to a provision in another law or an agreement that is in force on date of commencement of this Act.

Division IV: Deductions

General Deduction.

10. (1) (*a*) No deduction shall be made in calculating a person's income from employment.

(*b*) The following deductions shall not be made in calculating a person's income:-

(i) domestic expenses incurred by the person (section 197);

(ii) tax payable under this Act;

(iii) interest, penalties and fines payable to a government or a political subdivision of a government of any country for breach of any written law;

(iv) expenditure to the extent incurred by a person in deriving exempt amounts or final withholding payments;

(v) retirement contributions, unless they are included in calculating the income of an employee or consist of a contribution by an employer to a pension, provident or savings fund or a savings society, which is approved by the Commissioner-General subject to any specified conditions;

(vi) dividends of a company;

(vii) outlays or expenses for entertainment;

(viii) an amount that a person has transferred, in his financial accounts, to a reserve or provision for expenditures or losses not yet incurred but expected to be incurred in a future year of assessment;

(ix) amounts incurred on lotteries, betting or gambling, other than amounts incurred from conducting a business of lotteries, betting or gambling; or

(x) taxes or other levies specified by the Commissioner-General.

(2) Where a person is allowed a deduction for a payment from which the person is required to withhold tax under Division II of Chapter VIII, the deduction shall not be allowed until the tax withheld has been paid to the Commissioner-General.

(3) No deduction shall be allowed except as expressly permitted by this Act.

(4) Where more than one deduction applies, the most specific deduction shall be applied even if that results in the denial of a deduction.

Main deduction.

11. (1) In calculating a person's income from a business or investment for a year of assessment, expenses to the extent they are incurred during the year by the person and in the production of income from the business or investment, shall be deducted.

(2) No deduction shall be allowed under subsection (1) for an expense of a capital nature.

(3) In this section, "expense of a capital nature" includes an expense that secures a benefit capable of lasting longer than twelve months.

Interest expense.

12. For the purposes of section 11, the interest incurred by a person during a year of assessment under a debt obligation of the person shall be deemed to be incurred in the production of income to the extent that –

(*a*) where the debt obligation was incurred in borrowing money, the money is used during the year or was used to acquire an asset that is used during the year in the production of income; and

(*b*) in any other case, the debt obligation was incurred in the production of income.

Allowance for trading stock.

13. (1) For the purposes of calculating a person's income from a business for a year of assessment, in respect of trading stock of the business, the allowance calculated under subsection (2) shall be deducted.

(2) The allowance shall be calculated as –

(*a*) the opening value of trading stock of the business for the year of assessment; plus

(*b*) expenses incurred by the person during the year that are included in the cost of trading stock of the business; less

(*c*) the closing value of trading stock of the business for the year.

(3) The opening value of trading stock of a business for a year of assessment shall be the closing value of trading stock of the business at the end of the previous year of assessment.

(4) The closing value of trading stock of a business for a year of assessment shall be the lower of –

(*a*) the cost of the trading stock of the business at the end of the year; or

(*b*) the market value of the trading stock of the business at the end of the year.

(5) Where the closing value of trading stock is determined in accordance with paragraph (*b*) of subsection (4), the cost of the trading stock shall reset to that value.

Repairs and improvements.

14. (1) Expenses for the repair or improvement of depreciable assets and meeting the requirements of subsection (1) of section 11 of a person for any year of assessment shall be deducted irrespective of whether they are of a capital nature or not.

(2) The deductions referred to in subsection (1) granted for a year of assessment with respect to a depreciable asset of a person –

(*a*) shall not exceed –

(i) in the case of repair or improvement to a Class 4 depreciable asset, five percent of the written down value of the asset at the end of the previous year (paragraph 4(3) of the Fourth Schedule);

(ii) in all other cases, twenty percent of the written down value of the asset at the end of the previous year (paragraph 4(3) of the Fourth Schedule); and

(*b*) shall be allowed in the order in which the expenses are incurred.

(3) Excess expense for which a deduction shall not be allowed as a result of the limitation in subsection (2) shall be added to the depreciation basis of the asset year (paragraph (3) of the Fourth Schedule).

Research and development expenses and agricultural start up expenses.

15. (1) Research and development expenses and agricultural start up expenses meeting the requirements of subsection (1) of section 11 may be deducted irrespective of whether they are of a capital nature or not.

(2) In this section –

"agricultural start up expenses" means expenses incurred by the person in –

(*a*) opening up any land for cultivation or for animal husbandry;

(*b*) cultivating land referred to in paragraph (*a*) with plants;

(*c*) the purchase of livestock or poultry to be reared on land referred to in paragraph (*a*); or

(*d*) maintaining tanks or ponds or the clearing or preparation of any inland waters for the rearing of fish and the purchase of fish to be reared in such tank, pond or inland waters, as the case may be;

"research and development expenses" means expenses incurred by the person in –

(*a*) carrying on any scientific, industrial, agricultural or any other research for the upgrading of the person's business through any institution in Sri Lanka (or for any innovation or research relating to high value agricultural products, by the person or through any research institution in Sri Lanka); or

(*b*) the process of developing the person's business and improving business products or process,

which shall be beneficial to Sri Lanka, but shall exclude expenses incurred that are otherwise included in the cost of an asset under this Act.

Capital allowances and balancing allowances.

16. (1) For the purposes of calculating a person's income from a business for a year of assessment –

(*a*) the Capital allowances referred to in subsection (2) shall be deducted; and

(*b*) the balancing allowances referred to in subsection (4) shall be deducted;

(2) Capital allowances are –

(*a*) granted in respect of depreciable assets owned and used by a person at the end of a year of assessment in the production of the person's income from a business; and

(*b*) calculated in accordance with the provisions of the Second or Fourth Schedule to this Act.

(3) Capital allowances granted with respect to a particular year of assessment shall be taken in that year and shall not be deferred to a later year of assessment.

(4) Balancing allowances are –

(*a*) made in respect of depreciable assets -

(i) realised during a year of assessment; and

(ii) in respect of which Capital allowances have been granted in that year or an earlier year; and

(*b*) calculated in accordance with the provisions of the Second or Fourth Schedule to this Act.

Losses on realisation of business assets and liabilities.

17. (1) For the purposes of calculating a person's income from a business for a year of assessment, a loss of the person from the realisation during the year of assets and liabilities referred to in subsection (2) shall be deducted. The loss shall be calculated under Chapter IV.

(2) The assets and liabilities are –

(*a*) capital assets of a business to the extent to which the assets were used in the production of income from the business; and (*b*) liabilities of a business to the extent to which –

(i) in the case of a liability that is a debt obligation incurred in borrowing money, the money was used or an asset purchased with the money was used in the production of income from the business; and

(ii) in the case of any other liability, the liability was incurred in the production of income from the business.

Deductible amount of financial cost.

18. (1) The amount of financial costs deducted in calculating an entity's income, other than a financial institution from conducting a business or investment for a year of assessment shall not exceed the amount of financial costs attributable to financial instruments within the limit referred to in subsection (2).

(2) The limit shall be computed according to the following formula:-

A x B

Where:

'A' is the total of the issued share capital and reserves of the entity; and

'B' is –

(*a*) in the case of a manufacturing entity, the number 3; and

(*b*) in the case of an entity other than a manufacturing entity, the number 4.

(3) Financial costs for which a deduction is denied as a result of subsection (1), may be carried forward and treated

as incurred during any of the following six years of assessment, but only to the extent of any unused limitation in subsection (2) for the year.

(4) The Commissioner-General may specify the circumstances in which losses on financial instruments may only be set against gains on financial instruments.

(5) In this section, "reserves" exclude reserves arising from the revaluation of any asset.

Business or investment losses.

19. (1) In calculating the income of a person from a business for a year of assessment, the following shall be deducted:–

(*a*) an unrelieved loss of the person for the year from any other business; and

(*b*) an unrelieved loss of the person for any of the previous six years of assessment from the business or any other business.

(2) The person may choose the income calculation or calculations in which an unrelieved loss or part of the loss is deducted. However, where a loss can be deducted under subsection (1) it shall be deducted.

(3) Notwithstanding the provisions of subsections (1) and (2), where a person makes a loss and if the loss were a profit it would be taxed at a reduced rate, the loss shall be deducted only in calculating income taxed at the same reduced rate, a lower reduced rate or exempt amounts. If the loss were a profit and the profit would be exempt, the loss shall be deducted only in calculating exempt amounts.

(4) The provisions of subsections from (1) to (3) shall subject to the provisions in subsection (5), apply to

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.