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Tax Insights 2011

TAX INSIGHTS

We bring to you in this supplement a three section report, highlighting some insights on areas of change that bring both opportunities and challenges to your business.

The last tax proposals were presented in parliament in the year 2008. In the year 2009 the government did not present any tax proposals in parliament

The cessation of a 30 year conflict has brought about a positive challenge in seeking to encourage and fast track all lost opportunities in rebuilding and developing the country. The Government has sought to liberalize selected regulations that hitherto may have restricted business growth and expansion.

During the intervening period from the last budget several legislative amendments were made including the following:

(i) *Inland Revenue Amendment Act No. 19 of 2009*
(ii) *ESC Act No 16 of 2009*
(iii) *NBT Act No. 9 of 2009*

In addition to these amendments there were certain regulations that were published by gazette notice under the Inland Revenue Act.

The Government also appointed a Presidential Task Force to report on the required tax reforms and the final report of the Task Force was handed over to the President in October 2010.

In **Section 1 of** this document we have provided you with some insights derived from the above changes that may assist you in managing your tax affairs.

Exchange Controls

The extent to which exchange control need to be relaxed has been and may continue to be a long drawn debate. Recognizing that the right balance is essential for accelerated development, during the past year, certain exchange controls have been amended and relaxed and this document also highlights the more significant changes to the same, in **section 2.**

Accounting and Taxation-IFRS TAX series continued

We also continue in Section 3 in this supplement, our series on tax and accounting developments and in particular emerging tax matters consequent to the adoption of International Financial Reporting Standards (IFRS) in Sri Lanka and some specific issues that need to be addressed by businesses.

Section 1
Insights from recent legislative changes

1. Section 40B- lower tax rate for qualified employees of qualified employers

In order to retain certain professionals and other groups of individuals who might otherwise be part of the continuing brain drain in the country, individuals employed by selected entities were incentivized to work in Sri Lanka and be liable to personal income tax at a rate not exceeding 20%. It is however important that there are several conditions to be satisfied in meeting the eligible criteria as set out under Section 40B which is explained below.

Where the taxable income for any year of assessment commencing on or after 1st April 2009, of any qualified individual includes any profits from employment in foreign currency, such income would be taxable at a maximum rate of 20%. A qualified individual means an individual who is an employee and who provides in the course of his employment, any service being a service rendered in the course of any profession/ vocation as specified by the Commissioner General of Inland Revenue, under Section 13 (ddd) of the Inland Revenue Act and who is employed by a person whose income is also exempt under Section 13 (ddd) of the Inland Revenue Act. The professions specified by the Commissioner General of Inland Revenue for the purpose of both the exemption for the employer and the reduced rate for the employee is as follows.

(a) *"Services rendered by any individual as a member of an organized profession with a recognized standard of ability enforced before such person entering to it and recognized standard of conduct enforced while practicing in it;*

(b) *Accounting , book keeping or auditing;*

(c) *Tax advisory services;*

(d) *Services of a draftsman;*

(e) *Engineering services;*

(f) Software development, data processing, data base development or system designing;

(g) Advertising outside Sri Lanka;

(h) Researching outside Sri Lanka;

(i) Photography;

(j) Publishing outside Sri Lanka;

(k) Beauty culture, hair dressing, or modeling outside Sri Lanka;

(l) Services of a Valuer or Auctioneer;

(m) Services of a plumber, mason or carpenter;

(n) Quantity surveying;

(o) Health care services;

(p) Management of any agricultural property situated outside Sri Lanka;

(q) Any other services if such services is considered by the Commissioner- General in the interest of the national economy of Sri Lanka (effective from April 1, 2008).

2. Section 13 dddd - Services for payment in foreign currency exempt from Income Tax until 2011

The above is a time bound tax incentive that is presumably given with the intention of bringing into the country, foreign currency earnings of those who provide services to non-resident persons.

The income arising from any service provided by a person in Sri Lanka to a person outside Sri Lanka, whether such services are provided in or out side Sri Lanka such income if received in foreign currency through a bank in Sri Lanka is exempt from income tax until 31st March 2011 under Section 13 (dddd).

It should be noted that income arising from any services rendered as specified under section 13 (ddd) of the Act and referred to under paragraph 1 above will be exempt from income tax and this exemption is open ended as per present law.

3. Sri Lanka Development Bonds

Interest on Sri Lanka Development Bonds denominated in USD issued by Central Bank of Sri Lanka, is exempted from income tax. Profit on the sale of such bond is also exempted.

4. Sale of any sovereign bond

Profit on the sale of a sovereign bond denominated in foreign currency issued by Central Bank of Sri Lanka is exempted from income tax.

5. Economic Resurgence Certificate (ERC)

Interest on ERC, utilizing money, money lying to his credit in foreign currency in any account (deposited after 1st February 2009) opened in any commercial bank or specialized bank with the approval of Central Bank of Sri Lanka is exempted from income tax.

6. Transfer Pricing-not a new change but a developing tax issue

Transfer pricing regulations that were published in 2008 are now being implemented and thus should receive serious consideration by those who transact business with domestic and/or cross border related parties. Despite the fact that domestic transactions are normally not subject to international transfer pricing applications, the Sri Lanka guidelines do not limit same to cross border transactions and thus domestic intercompany transactions are within this purview.

Recent developments include special units of the Inland Revenue to focus on transfer pricing issues, preliminary attempts to gather information to have reasonable arms length prices although this is a serious challenge in an economy where public data bases are not available to get comparable prices. These challenges put an additional onus on tax payers to prove that their price is an arm's length price and this is now leading to a need to move on to Advance Pricing Agreements that are essential if the risk of transfer pricing disputes is to be minimized particularly where there are inter group transactions .

It is our view that transfer pricing will be a continuing key tax issue for most businesses since the period of evolution has been slow to mature and is still fraught with uncertainties. Despite many requests to restrict the application of transfer pricing to cross border transactions, it appears that tax authorities are also applying same to domestic transactions between related parties.

7. Employee share option scheme-internal guidelines issued to facilitate exemption by the Commissioner General of Inland Revenue on the basis of a "*reasonable scheme*".

Under Section 8 of the Inland Revenue Act the Commissioner General of Inland Revenue has now issued guidelines that determine whether an employee share ownership scheme would be "*reasonable*" in order to qualify for exemption from income tax. The criteria set out in the regulations in summary is as follows.

(a) The purpose of the scheme of awarding shares of the participating company should be to enable employees of the employer company (eligible to participate) to contribute more effectively towards increasing the efficiency of such employer company;

(b) Awarding of shares to any employee, directly or through an option plan, should be based on performance criterion and/or period of service of the employee as confirmed by the Board of Directors/ Management Board or Committee appointed by such Board of Directors/ Management Board of the employer company or relevant group company where applicable, unless the Articles of Associations of such Company or Group Company requires the confirmation of the Company's shareholders;

(c) The participating company should be a company listed in any Stock Exchange. Where such company is a company listed in the Colombo Stock Exchange, the scheme should confirm to Section 7 of the listing rules issued by such Stock Exchange;

(d) Employees within a grade/rank in the employer company should qualify for the scheme under similar terms and conditions being performance evaluation criteria and/or such other similar factors;

Since the above are issued as internal guidelines, it is necessary that any ESOP or similar scheme that is seeking to be tax exempt be formerly approved by the Commissioner General of Inland Revenue.

8. Nation Building Tax (NBT)

NBT which was a new tax imposed simultaneously with the reduction of the VAT rate from 15% to 12%, has caused significant tax and pricing issues to businesses. NBT also has a high income tax impact due to the non deductibility of 2/3rd of same for income tax purposes.

NBT imposed under the NBT Act No. 9 of 2009 levies NBT at the rate of 3% on the liable turnover on the following persons.

(a) On every importer on such import;

(b) Every manufacturer at the point of sale;

(c) Every service provided at the time of providing the service;

In the case of a manufacturer he is entitled to claim as an input credit NBT paid on raw materials at the point of import and local purchases against NBT payable by him on his turnover.

9. VAT on Financial services – Inconsistency in applications

Currently the institutions that are engaged in the business of providing financial services are liable to VAT at the rate of 20% on the value addition. However, the current definition of financial services provided in the Act is not sharp. For instance, the definition of financial services includes;

(a) The issue, allotment, transfer of ownership, drawing acceptance or endowment of any debt, security.

(b) The issue, allotment, transfer of ownership of any equity security.

It is not certain whether income such as gains and interest from the sale of debt security and treasury bills and repurchase agreements if carried out by a bank or financial institution comes within the above definitions.

This has resulted in the same transaction being treated differently for purpose of VATFS by different institutions. Further, the Act is not clear enough on the method of calculating the value addition attributable to the business of providing financial services, particularly where a business carries on both financial services liable to VATFS as well as non financial services liable to normal VAT. As a result of the lack of clarity in the definition of financial services and the method of attributing the value addition to financial services, there is significant inconsistency in the way VAT on financial services is calculated by different financial service companies. Since, the cost of VAT on financial services as a proportion of profits is significant, and such cost also forms part of a significant disallowed cost for purpose of income tax, these inconsistencies have resulted in an inequitable tax position where the same transaction is taxed differently in the hands of various tax payers, resulting in a significant difference in the effective tax rate of these institutions. It is therefore necessary that the ambiguity in the law be removed (both legally and administratively) and all tax payers are charged with the tax in a consistent manner.

10. VAT on Financial Services- changes to Economic Depreciation rates

Under the VAT Act economic depreciation is deductible in computing the value addition from the business of providing financial services. The Commissioner General of Inland Revenue has published the following rates to claim the economic depreciation against each class of asset.

Column I Assets	Column II Economic Depreciation (Rate per Annum)
Data Processing Equipment, their accessories or computer software	25%
Motor Vehicles	20%
Other Machinery, Plant or equipments, Furniture or fixtures	12 ½%
Any intangible assets (Other than goodwill)	10%
Buildings	6 ⅔%

11. A controversial change - Withholding of turnover tax payable to Provincial Councils-still pending clarity and finality

The Western Provincial Council by an order made under the gazette notification No. 1650/31 (23rd April 2010) imposed an obligation for the importers and manufacturers registered in the Western Province who sells goods to wholesalers or retailers for resale within the Western Provincial Council, to collect and remit 1% of the turnover of such registered manufactures and imports selling to such wholesalers and retailers. The tax so remitted to the Western Provincial Council, will be available as a credit to such wholesalers and retailers against whose turnover tax has been withheld.

The Provincial Council is currently in the process of registering those importers and manufacturers that would be potentially covered under the above gazette. Whilst this move by the Provincial Council is currently limited to the Western Province, many expect the other Councils also to follow a similar approach probably after testing the success of the scheme. There is also of growing debate as to whether the obligation imposed by the Western Province to collect the tax from persons who do not come within its jurisdiction is within the law or not. Be that as it may the move to withhold and pay the tax has caused much inconvenience and administrative cost to a large amount of tax payers who have already a heavy administrative cost in tax compliance.

12. Deemed Dividend Tax (DDT)

Another controversial tax, the DDT was introduced in 2007 to encourage companies to distribute retained earnings or pay DDT. This has raised issues relating to the need to retain funds within the business for expansion and other business needs. Although the DDT provision has taken into account the need to retain certain sums for the acquisition of capital assets, thefollowing issues are causing concerns.

- whether capital goods include investments in shares since many companies need to retain funds within the business to grow via acquisitions and share investments;

- relief where assets are acquired through financial or operating leases;

The above provision has now necessitated most companies to review their dividend policies and ensure that timely action is taken to avoid the payment of DDT.

13. Management Fees-deductibility

Section 26 of the Inland Revenue Act restricts the deduction of management fees to Rs 1mn or 1% of turnover. This provision was brought in to the statute prior to the introduction of transfer pricing provisions but remains as at date.

Where business is conducted either as a group or a cluster of associated enterprises, the need to provide and be paid for centralized services of a wide nature is common. However, the above provision which is now being invoked aggressively prevents a company from doing so without the intervention of the Commissioner General of Inland Revenue to approve a higher value. This also impacts certain sectors such as plantation companies, international hotels etc where the payment of management fees is an inherent feature of that business model.

Given the fact that there are other provisions in the tax law to capture payments that are either artificial or fictitious, it is now timely that the above provision be reviewed since the threshold of Rs 1million was imposed several years ago and has not since been revised.

14. Customs Duty changes effective from June 1, 2010

There was a significant revision of customs duty rates levied at point of importation with effect from June 1, 2010. The changes were to the 3%, 15% and 30% rate bands after which it is understood that the volume of imports had significantly increased.

15. Industry Specific Insights

Agriculture – the 5 year exemption on agriculture income will expire on 31st March 2011. In relation to tax exemptions on agro-processing the present law provides for relief under section 16. However due to the several ambiguities in relation to same it is expected that these concessions will be reviewed.

Telecommunications – there are several indirect taxes that apply to this sector and effective from January 1, 2010 the international telecommunication Operators Levy was revised. Further, it was also determined that effective from June 1, 2010 the operators shall levy interconnection charges at the rate determined by the Telecommunications Regulator.

Apparel exports- several exporters who were previously entitled to a full tax holiday under the Board of Investment regime are ending such tax exemption period and are now liable to income tax at a lower rate of 15% unless they have fulfilled the conditions specified for relocation or expansion in to designated areas.

Property Development – this sector is fragmented in to two categories in relation to VAT since only projects that have signed agreements with the Board of investment before April 2001 with an investment below USD 10million are exempt from VAT. Others including new projects are liable for VAT and consequently the pricing of these properties are impacted by this provision in the law.

Banking & Finance – attention is drawn to the fact, the Section 26 of the Inland Revenue Act restricts the deduction of bad debts to 1% of the book debts of the bank. Where there are specific provisions for bad debts that are warranted due to irrecoverable debts, such restriction imposes an additional tax cost to the financial institutions. In many instances the provisioning of same is mandated by the Central Bank of Sri Lanka and hence the additional tax cost is therefore a matter to be reviewed.

16. BOI tax exemptions-some insights

Where the preconditions for a tax holiday conferred under the BOI is dependent upon a future event (eg: reaching a specified level of investment or specified number of additional employment over a period of time), there is a doubt as to whether such enterprise will satisfy this condition although the tax relief has already commenced in the first year. Where the terms of the tax holiday is such that the tax exemption commences before the eligibility criteria is fully satisfied, the Inland Revenue has attempted to impose income tax on the premise that recovery of such tax may become time barred in the event the preconditions are not satisfied at the future date. Whilst it is clearly necessary that tax concessions are given only upon the satisfaction of pre-conditions, it is necessary that investors are not put in to an uncertain position in terms of recovery of tax since the raising of a statutory assessment provides room for recovery action unless taxes are held over. It is therefore necessary that these institutions mutually agree on the course of action that should be taken in these instances to ensure that investors who are more than likely to honor the conditions are not unduly burdened by the attempt to assess taxes that are not due.

On a similar note it is also worthwhile to mention that a critical matter to be identified when tax concessions are granted is the clear ascertainment of the date of commencement and date of expiry of the tax holiday period since such debates are more difficult to resolve at a later date.

It is also noteworthy to mention that the BOI now permits a merged entity (i.e. separate legal entities who have opted to do business under a single merged entity) to agree upon the manner in which the tax concession will apply. The entities concerned have to evaluate whether or not the benefits of the merger will outweigh some of the tax concessions that may have to be foregone in the process of agreeing to such common basis.

17. Recent amendments on VAT and NBT on Poultry products

By a notice published by the newspapers on 3rd November 2010 the Commissioner General of Inland Revenue has made the following amendments to the VAT and NBT Act effective from 13th October 2010, pending formal amendments to these Acts. As a result of this amendment the following food s will not be liable to both the VAT and NBT at the point of import.

Value Added Tax

(i) *Chicks for breeding (HS 0105.11.10)*
(ii) *Other chicks (HS 0105.11.20, 0105.11.90)*
(iii) *Meat of fowls (HS 0207.11, 0207.12, 0207.13, 0207.14)*
(iv) *Eggs (in shells, fresh or preserved) * (HS 0407.00.10, 0407.00.90)*
(v) *Eggs, not in shell, including egg white and egg yolks (HS 0408.11, 0408.19, 0408.91, 0408.99, 3502.11, 3502.19)*

Nation Building Tax

(i) *Chicks for breeding (HS 0105.11.10)*
(ii) *Other chicks (HS 0105.11.20, 0105.11.90)*

As per the paper notice the exemption from VAT in respect of the above products has been granted at the point of import. Thus, sale of the above products either by an importer or a manufacturer will continue to be liable to VAT at the rate of 1

Section 2
Exchange Controls

During the year 2010, the Controller of Exchange has published by gazette and in the form of directions relaxed certain restrictions with regard to foreign currency transactions. The following shows the type of relaxations and the person to whom such relaxations would be applicable.

In addition to these there have been recent announcements by the Central Bank of Sri Lanka that during the forthcoming budget there will be further liberalization in areas such as foreigners being permitted to buy corporate debt. This appears to be with the objective of channeling overseas funds in to private companies.

(a) General permission is granted to open accounts outside Sri Lanka in respect of the following

(i) *Persons resident in Sri Lanka who have proceeded outside Sri Lanka temporarily for business, studies or medical purposes;*

(ii) *An individual or a company or a firm registered in Sri Lanka who provides professional or vocational service outside Sri Lanka while being a resident in Sri Lanka;*

(iii) *An individual or a company or a firm registered in Sri Lanka who has been permitted by the Minister of Finance to invest outside Sri Lanka;*

(iv) *An individual or a company or a firm registered in Sri Lanka who has been permitted by the Central Bank of Sri Lanka to lend foreign currency abroad;*

(b) Securities Investment Account (SIA)

The following are eligible to open SIA's.

(i) *Foreign institutional investors;*

(ii) *Corporate bodies incorporated outside Sri Lanka;*

(iii) *Citizens of foreign states;*

(iv) Non- resident Sri Lankans;

(v) Sri Lankan professionals living in Sri Lanka who receives inward remittances;

(vi) Dual citizens who receives inward remittances ;

(c) Foreign currency accounts for International Service Providers and their employees.

The following persons are now entitled to open special foreign currency accounts for the following transactions.

(i) Any resident company or partnership registered in Sri Lanka or any individual in Sri Lanka rendering services while based in Sri Lanka to any person resident outside Sri Lanka;

(ii) Individuals employed by the eligible service providers specified above who are on a contractual basis and entered into agreement with such providers to be remunerated on part or entirely in foreign currency for the specified services rendered.

Section 3
Taxable profit-based on fair value or historical cost

In November 2009 we sent to you the first in our Thought Leadership® series on IFRS-Tax titled "Tax consequences of adopting IFRS". This contained broad insights of the significant issues and recommended that all concerned parties develop an action plan to enable the convergence to IFRS with the least amount of disruption and unwarranted unintended tax implications to any tax payer.

Since then IFRS implementation has moved forward in Sri Lanka (first IFRS financial statements in 2012 with 2011 comparatives) with no action plan in sight to address the tax issues. In this series we draw your attention to some specific examples that might illustrate the issue on a more practical note.

Where the accounting profits based on historical cost convention differed with the profit ascertained based on fair value, the possibility is high that tax can be imposed on fair value gains which do not constitute *"earned income"* for such period. If top line or bottom line taxes are computed on this basis there is a real danger that a tax payer may be called upon to pay taxes on a profit that is not in line with the cash profit generated for the period and thus may end up with a tax payment that is disproportionate to the ability to pay- that taxes be imposed where there is ability to pay is a cardinal principle in taxation and thus a violation of same would mean that money may have to be borrowed to pay taxes if fair value accounted profits are higher than actual cash profits.

Traditionally, a company's accounts would record the value of an asset at its cost (ie, the price the company paid for it). Under so-called *"fair value"* accounting, however, financial statement preparers can now record the value of an asset , at its Fair value (the price at which an asset could be exchanged between knowledgeable and willing buyers and sellers), this could be different to the price paid. So when this starting point is changed from "the amount paid (cost)" to *"fair value"*, it is inevitable for the entire tax system to get murky.

For many companies, the change to Fair Value measurement based financial statements will be significant, for two principal reasons: first, the general and increasing complexity of SLAS; and second, the fact that the new and improved standards are based, to a greater extent than any national accounting standards, on an accounting model that focuses clearly on the primacy of asset/liability recognition and measurement. This approach is based on the principle that a reporting entity should recognize in its balance sheet all those items (and only those items) that are considered to be assets and liabilities, and that income and expenses are determined by reference to increases and decreases in assets and liabilities. This focus on assets and liabilities as the primary elements of financial statements contrasts starkly with 'traditional' accounting practice. Until recently, accounting practice was generally based on historical cost and focused on accounting for transactions, underpinned by the concepts of *'realization'*, under which profits were not recognized until they were realized, *'matching'*, under which revenues were matched with costs, and *'prudence'*, which implied an element of conservatism, but was seen by some as a means by which companies could inappropriately smooth their profits through the creation of hidden reserves or excessive provisions. The inadequacy of the historical cost, transaction-based approach for dealing, in particular, with derivatives (which have little or no initial cost but can expose companies to very substantial financial risk) and diminutions in the value – impairments – of assets, encouraged standard-setters to espouse an asset/liability approach to recognition and a 'fair value' basis of measurement of assets and liabilities.

All in all, a very significant impact will be felt by the tax system (tax collector and tax payer alike) since the adoption of IFRS as SLAS will bring about a shift in the basis of taxation for reason that taxation policies and laws are closely linked to accounting practices and any change to the latter will invariably have consequences to all aspects of Sri Lanka taxation. As at date tax policies have not considered this matter although we have alerted policy makers regarding the need to do so.

This paper, being our second communication in the IFRS-TAX series, attempts to provide the reader a broad insight as to tax implications arising from this move. It is hoped that this will assist in developing an action plan that needs to be put in to place so that SLAS/ IFRS implementation is achieved with the least amount of disruptions to the tax system.

The following IFRS are identified as having a potentially HIGH impact on the financial statements. Accordingly it may also result in a high tax impact. These areas would also impact a number of other functional and operational areas and may require effort in developing a new process and/or IT system modifications to comply with IFRS.

(i) Revenue recognition – multiple elements, customer loyalty programs, agreements for the construction of real estate etc;

(ii) Share capital- debt vs. equity;

(iii) Property Plant & Equipment – component accounting;

(iv) Financial instruments – Initial recognition and subsequent measurement at fair value, derivatives & impairment, de-recognition of financial assets and liabilities;

(v) Arrangements that contain Lease;

(vi) Related Party disclosures – stringent process to identify and disclose;

(vii) Presentation and Disclosure;

The following examples illustrate some areas where the search for clarity in uncertain tax positions needs to commence.

1. Borrowings at Concessionary Rate

It is common for companies to grant loans to their employees and/or related companies at below market concessionary rates of interest or in some cases at no interest at all. Under a historical cost (SLGAAP) method such loans would be recorded in the financial statements at the actual sums borrowed and the revenue recognized would be the actual interest earned. i.e. if a loan is given at zero interest, no income would be accounted for.

However, under the IFRS method both the loan and the interest income would be recorded at their fair market value. For instance if the company granted a loan of Rs. 1 million at a concessionary interest rate of 4% and the market rate of interest was 15%, under the historical cost method the loan granted would have been recorded in the balance sheet as Rs. 1 million receivable and the interest income of Rs. 40,000/= as revenue. Under IFRS the revenue that is recognized would increase to the equivalent of 15% rate of interest and the differential (benefit to employee of the reduced rate) would be accounted for as a staff cost. Thus both revenue (interest income) as well as staff cost values would be reported differently under IFRS, although the resultant net income may remain the same.

Uncertain Tax Issues:

The additional revenue recorded (although it may be a notional or book entry) may attract taxes that are based on gross revenue. In the case of a financial institution, the value addition will change and taxes such as VATFS could arise.

Accounting for the employee benefit will also disclose and quantify the benefit from employment that arose as a result of the concessionary loan and raise a possibility of such benefits being taxed as profits from employment.

2. Provision for Bad Debts

Under Section 25 of the Inland Revenue Act, bad debts incurred during any year of assessment is deductible in arriving at the taxable profits subject to such deduction being determined as reasonable by the Commissioner General of Inland Revenue and in the case of banks, subject to a cap of 1% of book debts.

The deduction of bad debts largely affect banks, leasing companies and finance companies due to the nature of their operations and thus the inability to deduct any such provision results in a high tax cost.

Presently, the basis for determining whether a debt has to be provided for is under the regulations imposed by the Central Bank of Sri Lanka. According to these regulations which also form a part of the Sri Lanka Accounting Standards, the provision is made against each debtor by reference to the period the debt is outstanding. The Department of Inland Revenue has by and large accepted the Central Bank regulations as a reasonable basis for determining whether the bad debts is incurred and thereby tax deductible.

With the introduction of IFRS the provision for bad debts made in the financial statements may shift from regulations governed the Central Bank, to an estimate of the fair value of the debt which primarily takes into account the future cash flows to be generated from the recovery of the debt.

Uncertain Tax Issues:

Under the provisioning criteria of IFRS, there would be a greater onus placed on the tax payer to convince the Commissioner General of Inland Revenue that the amount of bad debts provided in the accounts (under a future cash flow or fair value considerations) represents bad debts incurred during that period. Where such evidence fails to establish that the debt is both specific and incurred, there could be a tendency to disallow it on the basis that it is a general provision unless the present conditions in the tax law for permitting the deduction of bad debts is revised.

3. Revenue Recognition

Multi Element Contracts

Entities might enter into various types of agreements with their customers when selling products and services where these are bundled together. The more significant revenue recognition issues include multi element contracts, extended warranties, discounts, etc. For example, before IFRS, in the case of a multi element contract which primarily is for the sale of goods with installation or free after sales services of that good, the entire contract value would have been recognized as sale of goods.

Under IFRS the revenue may be split between the value of goods and the services – the latter being the installation charges or the after sales services value. Generally in multi element contracts the invoice may not mention a separate value for the service portion and hence a fair value assessment will also have to be done.

Uncertain Tax Issues:

When contracts are split as above, the characterization of revenue will change as for examples between sale of goods and services. Since different sources of income could be subject to different taxes (eg: trading is subject to turnover tax whilst services are subject to VAT and NBT) such recognition is likely to cause changes in the tax position.
Notionally recognizing revenue streams as required by IFRS can cause issues for certain sales based taxes such as VAT and NBT. For instance, if a certain good is exempt from VAT, and no VAT invoice is raised but if the financial statements disclose separate revenue for goods and services it is very likely the assessor will challenge the exemption of VAT for the whole invoices value. The assessor may grant exemption only for the value goods and not services. Similarly issues could arise for NBT as well where the sale of certain goods which would otherwise not be liable for NBT

will now be liable for the service portion.

The above tax issue may arise more significantly for companies in the IT, construction, telecommunication sectors and where the sale of goods / services, generally have multiple elements.

4. Property Plant & Equipment-component accounting

For capital intensive companies, accounting for capital or fixed assets will change under IFRS due to the application of the component approach. This involves identifying the significant components in each capital asset acquisition. Once this is done each component is accounted for separately and depreciated over the relevant useful life rather than the life if the asset as a whole.

Accelerated capital allowances have long been a tax incentive for capital incentive companies. In Sri Lanka capital allowances vary according to the category of assets. Presently once an asset is categorized as a whole (eg : commercial building) capital allowances are claimed under one category.

Uncertain Tax Issues:

Where component accounting is done there is likely to be different rates for capital allowances depending on the categories that the components are classified. In certain instances the eligibility for capital allowances may even be challenged since all expenditure of a capital nature do not qualify for capital allowances under the present tax laws.

5. Share capital-Debt vs. Equity

Where an entity is financed using various types of equity and debt instruments, IFRS requires that it must be recognized in accordance with the substance of the contractual arrangement. For example a company may have preference share capital which is presently recognized as equity and the return thereof recognized as a dividend.

Under IFRS certain types of equity (eg: non convertible preference shares) may be considered in substance as a Debt rather than equity. Accordingly any dividends may be recognized as interest. Certain other instruments such as convertible preference shares may even be considered to have a portion of debt and equity and must e split and accounted for separately.

Uncertain Tax Issue:

The characterization of an asset or liability as either debt or equity has key tax implications since payments such as interest or dividends have varying tax implications. Where interest is recognized as a dividend, it may not be tax deductible whilst dividends being recognized as interest may render the recipient of such interest becoming liable to pay certain direct and indirect taxes that do not apply to dividends.

6. Related Party Disclosures

IFRS requires that an entity has a rigorous process through which it identifies relationships and transactions with related parties. Such transactions are disclosed in detail in the financial statements.

Uncertain Tax Issues:

Most tax laws in Sri Lanka provide that transactions with related parties need to be at an arms length price. Recent tax statutes have brought in transfer pricing, thin capitalization and similar provisions that are intended to impose taxes on open market values. Where such open market values are difficult to ascertain due to the absence of reckonable arms length prices, the increased disclosure of related party transactions under IFRS would require a greater scrutiny to be made in relation to pricing of such transactions to ensure that they meet the arms length test. In the absence of reliable data to ascertain open market prices this would be a challenge for both the tax administration as well as tax payers.

Presentation and Disclosure

Overall the adoption of IFRS will result in a significant change in the presentation and disclosures made in the financial statements. These changes will clearly result in tax consequences due to reasons such as changes in income recognition, characterization of income. Recognition and characterization of capital assets, accounting for notional income or expenses as in the case of below market interest or free services or warranty costs. Whilst these would be continuing issues for tax payers, the first year adoption of IFRS may result in a greater impact since there may also be adjustments on account of opening balances. For all these reasons and more, it appears to be an immediate imperative that there be a considered action plan to reconcile the bases that would apply to taxation with what is likely to be used under IFRS so that entities are not only prepared for the conversion in to IFRS but also for the tax consequences arising thereof.