



# ICLG

The International Comparative Legal Guide to:

## Corporate Tax 2014

**10th Edition**

A practical cross-border insight into corporate tax work

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## General Chapter:

1	<b>The X Factor</b> – William Watson, Slaughter and May	1
---	---	---

## Country Question and Answer Chapters:

2	<b>Albania</b>	Boga & Associates: Alketa Uruçi & Andi Pacani	7
3	<b>Andorra</b>	Arqués Ribert Junyer Advocats: Daniel Arqués i Tomàs & Mireia Ribó i Bregolat	12
4	<b>Argentina</b>	Bulit Goñi & Tarsitano: Alberto Tarsitano & María Inés Giménez	19
5	<b>Australia</b>	Greenwoods & Freehills: Adrian O'Shannessy & Andrew Mills	26
6	<b>Belgium</b>	Vanhaute Attorneys: Patrick Vanhaute	33
7	<b>Brazil</b>	Mattos Filho, Veiga Filho, Marrey Jr. E Quiroga Advogados: Luiz Felipe Centeno Ferraz & Renata Correia Cubas	42
8	<b>Bulgaria</b>	Georgiev, Todorov & Co.: Georgi Kostolov	48
9	<b>Canada</b>	Thorsteinssons LLP: Michael Colborne & Michael McLaren	54
10	<b>Denmark</b>	DELACOUR Law Firm: Morten Brehm Jensen & Kristian Tokkesdal	59
11	<b>Estonia</b>	Aivar Pilv Law Office: Jaak Siim & Epp Lumiste	65
12	<b>France</b>	Bredin Prat: Yves Rutschmann & Marion Méresse	74
13	<b>Germany</b>	P+P Pöllath + Partners: Dr. Michael Best & Dr. Nico Fischer	81
14	<b>Ghana</b>	Bentsi-Enchill, Letsa & Ankomah: Seth Asante & Frank Nimako Akowuah	88
15	<b>Greece</b>	Kyriakides Georgopoulos Law Firm: Panagiotis Pothos	94
16	<b>Iceland</b>	LOGOS Legal Services: Bjarnfreður Ólafsson	101
17	<b>India</b>	Khaitan & Co: Sanjay Sanghvi & Ritu Shaktawat	106
18	<b>Indonesia</b>	Ali Budiardjo, Nugroho, Reksodiputro: Freddy Karyadi	112
19	<b>Ireland</b>	Mason Hayes & Curran: John Gulliver & Robert Henson	117
20	<b>Italy</b>	Legance: Marco Graziani & Claudia Gregori	124
21	<b>Japan</b>	Nagashima Ohno & Tsunematsu: Yuko Miyazaki & Kenji Horiuchi	134
22	<b>Kosovo</b>	Boga & Associates: Alketa Uruçi & Andi Pacani	143
23	<b>Liechtenstein</b>	Batliner Gasser: Dr. Christian Presoly & Benedikt Koenig	147
24	<b>Lithuania</b>	Juridicon Law Firm: Laimonas Marcinkevičius & Ingrida Steponavičienė	154
25	<b>Luxembourg</b>	MNKS: Raquel Guevara & Remi Slama	163
26	<b>Macedonia</b>	Debarliev, Dameski and Kelesoska: Dragan Dameski & Elena Nikodinovska	170
27	<b>Malta</b>	Avanzia Taxand Limited: Walter Cutajar & Mary Anne Inguanez	175
28	<b>Mexico</b>	Calderón, González y Carvajal, S.C.: Alejandro Calderón Aguilera & Arturo Carvajal Trillo	182
29	<b>Nigeria</b>	Ikeyi & Arifayan: Nduka Ikeyi & Taofeek Shittu	188
30	<b>Norway</b>	Advokatfirma Ræder DA: Rolf H. Nicolaissen & Sigurd G. Tuntland	194
31	<b>Peru</b>	CASAHIERRO Abogados: Percy Castle & Fabrizio Fernandez-Dávila	200
32	<b>Poland</b>	Gide Loyrette Nouel: Maciej Grela & Ewa Żbikowska	206
33	<b>Russia</b>	Lidings: Stepan Guzey, PhD	212
34	<b>Rwanda</b>	Lex Chambers Ltd: Isaac Mockey Bizumuremyi	216

Continued Overleaf →

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## Country Question and Answer Chapters:

35	<b>South Africa</b>	Glyn Marais Incorporated: Richard William Douglas Glyn & Richard Charles Wilson	220
36	<b>Spain</b>	Uria Menéndez: Rafael Fuster & Alonso Ramallo	226
37	<b>Sri Lanka</b>	Nithya Partners: Naomal Goonewardena & Sheranka Madanayake	233
38	<b>Sweden</b>	Kilpatrick Townsend & Stockton Advokat KB: David Björne	239
39	<b>Switzerland</b>	Lenz & Staehelin: Heini Rüdüsühli & Jean-Blaise Eckert	246
40	<b>Turkey</b>	Pekin & Pekin: Fırat Yalçın & Mehmet Onur Çeliker	255
41	<b>Ukraine</b>	B.C. Toms & Co: Bate C. Toms	263
42	<b>United Kingdom</b>	Slaughter and May: Zoe Andrews & William Watson	272
43	<b>USA</b>	Paul, Weiss, Rifkind, Wharton & Garrison LLP: Jeff Samuels & Brad Okun	279

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## EDITORIAL

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Welcome to the tenth edition of *The International Comparative Legal Guide to: Corporate Tax*.

This guide provides the international practitioner and in-house counsel with a comprehensive worldwide legal analysis of the laws and regulations of corporate tax.

It is divided into two main sections:

One general chapter. This chapter discusses what makes the difference between acceptable tax mitigation and unacceptable tax avoidance.

Country question and answer chapters. These provide a broad overview of common issues in corporate tax laws and regulations in 42 jurisdictions.

All chapters are written by leading corporate tax lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor William Watson of Slaughter and May for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at [www.iclg.co.uk](http://www.iclg.co.uk).

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# Sri Lanka



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### 1 Tax Treaties and Residence

#### 1.1 How many income tax treaties are currently in force in Sri Lanka?

Sri Lanka has entered into treaties relating to the avoidance of double taxation with 45 states, most recently with Luxembourg in January 2013. These include both comprehensive and limited treaties. Comprehensive treaties form the vast majority of such treaties and are in force with the USA, the UK and most of Western Europe, as well as Russia and Australia. Much of Asia including China, India, Japan and Singapore are also covered under such comprehensive treaties, as is most of the Middle East. Limited treaties form a small minority of the treaties in force and are currently entered into with Hong Kong, Oman, Jordan and Saudi Arabia to cover limited areas such as shipping and air transport.

#### 1.2 Do they generally follow the OECD or another model?

The United Nations Model Convention has been broadly followed, subject to certain variations influenced by the OECD Model.

#### 1.3 Do treaties have to be incorporated into domestic law before they take effect?

Yes. The income tax legislation (i.e. the Inland Revenue Act No. 10 of 2006, as amended (“IRA”)) specifically provides that such treaties need to be approved by a resolution of Parliament and published in the *Gazette* in order for the same to have the force of law in Sri Lanka.

#### 1.4 Do they generally incorporate anti-treaty shopping rules (or “limitation on benefits” articles)?

Such articles are generally not incorporated.

#### 1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

The IRA provides that once the treaty has been approved by a resolution of Parliament, it shall have the force of law in Sri Lanka “notwithstanding anything in other written law”. However, it is likely that any subsequent legislation which specifically seeks to amend the treaty would have an overriding effect.

#### 1.6 What is the test in domestic law for determining corporate residence?

In terms of the IRA, a corporate entity is deemed to be resident in Sri Lanka either in the instance where it has its registered or principal office in Sri Lanka, or where the control and management of its business is exercised in Sri Lanka.

### 2 Transaction Taxes

#### 2.1 Are there any documentary taxes in Sri Lanka?

Stamp duty is the documentary tax applicable in Sri Lanka and is payable on a limited number of instruments such as promissory notes, share certificates and share transfer forms, as well as on conveyance documents such as leases, mortgages, deeds of transfer and deeds of gifts.

The rates of stamp duty vary depending on the type of instrument and are generally *ad valorem* taxes. Stamp duty on transfers of land is charged on the value of the land at 3% for the first Rs. 100,000 and 4% for the remaining value and gifts of land attract stamp duty of 3% for the first Rs. 50,000 and 2% thereafter. Mortgages attract a stamp duty of 0.1% of the secured amount and leases are charged at 1% of the lease payments for the entire term, including premiums, up to a maximum term of 20 years.

Stamp duty of 0.5% is payable on the issuance of shares and the transfer of shares. The rate is applied on the value of the shares issued/transferred and this may or may not be equivalent to the consideration exchanged.

#### 2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

VAT legislation has been operative in Sri Lanka since 2002 (which replaced the previous GST regime) and is payable (in general) on the supply in Sri Lanka of goods and services and on the importation of goods into Sri Lanka. Currently, the applicable rate is 12% and exports are generally zero-rated.

There is also a special type of VAT, known as “Financial Services VAT”, which is chargeable at the rate of 12% on persons supplying financial services. Unlike conventional VAT however, Financial Services VAT is not payable on the basis of turnover, but on a value addition basis.

Sri Lanka also has Nation Building Tax (“NBT”), which came into operation in 2009. It is a tax payable by any person that imports any

article (other than personal baggage) into Sri Lanka, carries on the business of manufacture of any article, carries on the business of providing a service of any description or carries on the business of wholesale or retail sale of any article. NBT is payable currently at a rate of 2% of the liable turnover of such person. In the case of distributors, only 25% of their liable turnover is subject to NBT, whereas for wholesale/retail business, only 50% of liable turnover from such retail/wholesale sale is subject to NBT.

### 2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Both VAT and NBT are subject to a vast number of exemptions which are frequently modified.

VAT, for example, is not chargeable on the supply or import of certain basic commodities and agricultural products. Essential services such as the supply of healthcare, public transport and residential accommodation are also exempt. Until recently, wholesale and retail trade was also VAT exempt. However, following recent amendments to the VAT law, VAT registration is now required even in respect of wholesale and retail trade where turnover (including VAT exempt supplies) exceeds Rs. 500 million per quarter and VAT would then become chargeable on the liable turnover from such wholesale and retail trade.

There is also a Simplified VAT ("SVAT") system whereby suppliers to businesses which are zero-rated are entitled to refrain from charging VAT on transactions with such zero-rated persons, so long as certain formalities are complied with.

NBT is not chargeable on supplies such as banking or finance services (although a recent amendment brought Islamic financial transactions within the ambit of NBT), medical services, electricity and water supplies and transport services.

As an incentive to small and medium enterprises, an exemption from VAT and NBT was granted in 2013 to any person having an annual liable turnover of less than Rs. 12 million, from all businesses carried on by such person. The quarterly threshold for VAT and NBT liability would therefore be Rs. 3 million.

### 2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

The excess of input VAT over output VAT can be claimed by persons who are liable to VAT and as long as they are registered under the VAT legislation.

It is important to note that it is only the VAT that has been paid on the goods or services used for the purposes of the taxable supply of such person on which output VAT is paid that can be recovered as input VAT. As such, input VAT is not claimable on private expenses.

Input VAT can only be recovered up to a value equivalent to the output VAT of such person. Any excess input VAT can be brought forward to future periods, but again is subject to the same restriction that recoverability cannot exceed 100% of output VAT.

Like VAT, manufacturers (although not service providers) are entitled to NBT tax credits against input NBT paid by the manufacturer on any goods which were used by him in manufacturing NBT liable goods. Once again, no refunds are permitted, but any excesses can be brought forward to future periods.

### 2.5 Are there any other transaction taxes?

Transfer tax used to be imposed in Sri Lanka when a non-Sri Lankan citizen (or company whose non-Sri Lankan shareholding exceeds

25%) acquired immoveable property in Sri Lanka, subject to a limited number of exceptions. The tax was imposed at 100% of the value of the property. The enactment imposing such tax has now been repealed. Regulations have however been circulated restricting the transfers of land to non-Sri Lankans (or companies whose non-Sri Lankan shareholding exceeds 50%), subject to specified exemptions. It is very likely that a new enactment imposing a similar transfer tax on the exempted transfers to non-Sri Lankans would be enacted in the very near future and there have been indications that such tax would extend to leases granted to non-Sri Lankans as well. Currently we have no indication as to what the tax rate on transfers or leases of land to non-Sri Lankans would be.

Other notable taxes are as follows:

- Share Transaction Levy: This levy is charged on share transactions on the Colombo Stock Exchange and is payable by both the buyer and the seller at the rate of 0.3% each on the value of the shares transacted.
- Telecommunication Levy: A levy of 20% is payable on telecom services, with a concessionary rate of 10% applicable to the provision of internet services.
- Construction Industry Guarantee Fund Levy: This is a levy charged on every construction contractor on the contract value and the rate varies from 0.25% to 1%. There are certain exemptions from this levy available for special projects.
- Special Commodity Levy: This a levy imposed at import point on identified commodities. The rates may be *ad valorem* or on a specific basis and depend on the type of commodity.

### 2.6 Are there any other indirect taxes of which we should be aware?

Economic Service Charge (ESC), which is in the nature of a minimum alternative tax, is payable by businesses whose aggregate turnover exceeds Rs. 50 million in one quarter in a year of assessment. ESC is charged at the rate of 0.25% of liable turnover.

The basis of ESC has been fundamentally changed by the recent amendments. Whereas ESC used to be in the nature of an advance payment of tax, it is now the case that persons whose profits were liable to income tax in the immediately preceding year of assessment are exempt from ESC to the extent of such liable income. As such, ESC is now payable only on the turnover of any business where the profits to which such turnover relates are not liable to income tax whether by reason of any tax exemption or through the incurring of losses during that period. It continues to be the case that ESC can be set off against the income tax liability of the business in that year of assessment, and where such liability is less than the ESC, it can be brought forward for the next 4 years.

The other significant indirect tax is customs duty, which is levied at variable rates on all goods, wares and merchandise imported into or exported out of Sri Lanka. There are also a multitude of taxes and levies imposed at import point (which is sometimes product dependent) which are in the nature of excise duties, surcharges and cess. The Ports and Airport Development Levy is also noteworthy and could, together with the aforesaid excise duties, surcharges and cess, effectively increase the nominal rate of customs duty considerably.

## 3 Cross-border Payments

### 3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

The IRA provides that a company resident in Sri Lanka must withhold 10% of the gross dividends distributed to its shareholders.

There are certain exemptions to this general rule, most notably dividends paid by unit trusts or mutual funds approved by the Securities and Exchange Commission, and dividends paid out of profits which arose from dividends received from other Sri Lankan resident companies.

This withholding tax applies to all shareholders, not just non-residents.

### 3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties paid to a non-resident are chargeable with income tax at the rate of 15%. There is provision for withholding tax on royalties paid to be deducted by the payer at the rate of 20% or at the rate prescribed in the applicable double tax treaty.

### 3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Following recent amendments to the IRA, interest accruing to persons outside Sri Lanka from any loan granted by such person to a local company or from an investment in any security or bond issued by a local company (where such investment was made using foreign currency brought into Sri Lanka) will be exempt from income tax, provided that such loan was granted or investment was made on or after 1<sup>st</sup> April 2012. Given the aforesaid exemptions, withholding tax would be inapplicable.

Furthermore, the IRA also provides an exemption from income tax (including withholding) on interest and discount earned after 1<sup>st</sup> January 2013 by any person on a corporate debt security quoted on any stock exchange approved by the Securities and Exchange Commission of Sri Lanka.

### 3.4 Would relief for interest so paid be restricted by reference to “thin capitalisation” rules?

Interest paid by a company on loans received from other members of its group is only tax deductible to the extent that such interest does not exceed 4 times the aggregate of its share capital and reserves. Where such subsidiary is a manufacturing company, the allowable deduction is restricted to 3 times the aggregate of its share capital and reserves.

### 3.5 If so, is there a “safe harbour” by reference to which tax relief is assured?

There are no “safe harbour” rules.

### 3.6 Would any such rules extend to debt advanced by a third party but guaranteed by a parent company?

The current “thin capitalisation” regime does not extend to such debts which have been guaranteed by a parent company and there are no other rules which cover such debts.

### 3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

There are no further restrictions.

### 3.8 Is there any withholding tax on property rental payments made to non-residents?

Withholding tax on rent payments made to non-residents is applicable at the rate of 20% or at the rate prescribed in the applicable double tax treaty.

### 3.9 Does Sri Lanka have transfer pricing rules?

Yes, the IRA specifically provides that transactions entered into between two associated undertakings shall be ascertained having regard to the arm’s length price.

The Commissioner General has furthermore published detailed Transfer Pricing Regulations which provide for methods of ascertaining the arm’s length price, assessing comparability and specifying the necessary records to be kept.

At present, the enforceability of these Regulations is minimal. However, this may change as recent amendments to the IRA brought in more stringent provisions for the ascertainment of arm’s length pricing in international transactions, including the introduction of a “Transfer Pricing Officer” who would have the power to determine such pricing where the computations put forward by the transacting parties are unsatisfactory.

## 4 Tax on Business Operations: General

### 4.1 What is the headline rate of tax on corporate profits?

The highest tax bracket generally is 28%. However, the import and sale or the manufacture and sale of liquor and tobacco products are taxed at 40%.

### 4.2 When is that tax generally payable?

The year of assessment in Sri Lanka is from 1<sup>st</sup> April in a given year to 31<sup>st</sup> March in the immediately succeeding year.

Income tax is payable on a self-assessment basis in 4 quarterly instalments on or before 15<sup>th</sup> August, 15<sup>th</sup> November and 15<sup>th</sup> February in a given year of assessment and 15<sup>th</sup> May in the next year of assessment, with the final payment being due on 30<sup>th</sup> September. The income tax return needs to be filed on or before 30<sup>th</sup> November in the next year of assessment.

### 4.3 Is the tax base accounting profit subject to adjustments, or something else?

The tax base for calculating corporate income tax would be the commercial accounts of a company, with adjustments made to comply with the provisions of the IRA.

With the introduction of IFRS in Sri Lanka from January 2012, the Inland Revenue Department is currently in the process of issuing detailed guidelines in relation to adjustments that need to be made to such IFRS compliant accounts in order to arrive at taxable profits.

### 4.4 If the tax base is accounting profit subject to adjustments, what are the main adjustments?

The main differences would be that certain types of income may be exempt from tax, whereas certain types of expenses would not be tax deductible. Furthermore, there may be certain items which are

considered as income for tax purposes though not shown in the commercial accounts and certain expenses not shown in the commercial accounts which may be tax deductible.

In terms of income, the main adjustments would be the removal of income from capital gains. In terms of deductibles, a significant difference would be depreciation charges in the commercial accounts and the tax deductible capital allowances charged to ascertain taxable income. Only certain types of assets have the benefit of capital allowances and only at specified rates which would differ from the depreciation calculations in the commercial accounts.

With the recent implementation of IFRS in Sri Lanka, these differences will increase. From initial drafts of guidelines to be issued by the Inland Revenue Department in this regard, detailed schedules would need to be provided to the Inland Revenue Department disclosing the IFRS related computations. For example, regarding property, plant and equipment, adjustments would be required in relation to imputed interest, revaluations and componentisation as these matters are disregarded for the purposes of tax. Furthermore, detailed disclosures of changes in fair value and impairment would also need to be made as profits and losses accruing therefrom may be inapplicable for tax purposes.

#### 4.5 Are there any tax grouping rules? Do these allow for relief in Sri Lanka for losses of overseas subsidiaries?

There are no provisions for group relief in Sri Lanka.

#### 4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, there is no distinction made between distributed and retained profits.

However, it should be noted that “Deemed Dividend Tax” is applicable in Sri Lanka. The IRA provides that where a company has distributed less than 10% of its distributable profits in a given year (for clarity, we can call it “Y1”), the company is liable to deemed dividend tax in the next year of assessment (i.e. “Y2”), at the rate of 15% on 33⅓% of the distributable profits of the company in Y1 less the amounts actually paid as dividends in the 18 months starting from the commencement of Y1.

#### 4.7 Are companies subject to any other national taxes (excluding those dealt with in “Transaction Taxes”) - e.g. tax on the occupation of property?

We have dealt with the more significant taxes in the preceding sections. However, the following may also be noted:

- Tourist Development Levy (TDL) is payable by every institution licensed under the Tourist Development Act No. 14 of 1968 other than travel agents at a rate of 1% on liable turnover after deducting VAT and service charges.
- Liquor Licences: There are annual licence fees imposed on persons who are involved in the sale of liquor.
- Port and Airport Development Levy (PAL) is charged at 5% on CIF value of imports, other than on specified exempt articles.
- Betting and Gaming Levy: In addition to fixed annual levies applicable to different types of betting and gaming activities carried out in Sri Lanka, a further 5% on the gross collections from bookmaking/gaming business is payable on a monthly basis, in lieu of other indirect taxes.

#### 4.8 Are there any local taxes not dealt with in answers to other questions?

There are rates payable at the local authority/municipal level in relation to occupation of immoveable property based on the assessed value of such property. In addition, a trade/business tax is also payable where a trade or business is being carried on in such property.

## 5 Capital Gains

#### 5.1 Is there a special set of rules for taxing capital gains and losses?

After 1<sup>st</sup> April 2002, capital gains are no longer subject to taxation. As such, there are no special rules relating to taxing capital gains and losses.

#### 5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

This is not applicable in Sri Lanka.

#### 5.3 Is there a participation exemption for capital gains?

This is not applicable in Sri Lanka.

#### 5.4 Is there any special relief for reinvestment?

This is not applicable in Sri Lanka.

#### 5.5 Does Sri Lanka impose withholding tax on the proceeds of selling a direct or indirect interest in local assets/shares?

This is not applicable in Sri Lanka.

## 6 Local Branch or Subsidiary?

#### 6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no taxes imposed on the formation of a subsidiary.

#### 6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no separate taxes or fees that would be significant; however, the incidence of income tax will vary depending on whether it is a locally-formed subsidiary or a branch of a non-resident company.

A locally-formed company is deemed to be resident in Sri Lanka and as such is liable to pay income tax on all its profits and income, wherever they arise or derive from, whether in Sri Lanka or overseas. Branches of a non-resident company on the other hand would still be considered as non-resident entities and are only taxable on the profits and income arising out of or derived from Sri Lanka.

It should be noted, however, that the standard Double Taxation Treaty provides for the concept of a “permanent establishment” and

it is only if the branch office satisfies such criteria that the profits attributable to such permanent establishment will be subject to income tax in Sri Lanka.

### 6.3 How would the taxable profits of a local branch be determined in its jurisdiction?

Taxable profits would be such profits and income arising in or deriving from Sri Lanka. This means that all profits and income derived from services rendered in Sri Lanka or from property in Sri Lanka or from business transacted in Sri Lanka, whether directly or through an agent, would be taxable. Head Office expenses incurred in relation to the branch office would be tax deductible so far as such expenses do not exceed 10% of the taxable profits of the branch office.

The above is subject to the provisions relating to “permanent establishments” that may be applicable when a standard Double Taxation Treaty is in force.

### 6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There are no such taxes currently in force. A branch would be taxed at 28%, which is the corporate rate of income tax in Sri Lanka.

### 6.5 Would a branch benefit from double tax relief in its jurisdiction?

The tax treaty would only provide for residents of a contracting state to be entitled to treaty relief. Since a branch does not satisfy such criteria, they would not be entitled to the benefit of such tax treaty.

### 6.6 Would any withholding tax or other similar tax be imposed as the result of a remittance of profits by the branch?

Profit remittances of a non-resident company are charged with income tax at the rate of 10% of such remittances. This is the liability of the non-resident company in Sri Lanka and the payment is not made as withholding tax.

## 7 Overseas Profits

### 7.1 Does Sri Lanka tax profits earned in overseas branches?

Yes. If the company is resident in Sri Lanka, all its profits and income – wherever it arises from – will be subject to income tax in Sri Lanka. As such, the overseas branches will be subject to the same income tax laws. However, there are several exemptions provided in the IRA for activities carried on outside Sri Lanka and for services rendered outside Sri Lanka.

### 7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

As long as such dividends have been remitted into Sri Lanka through a bank, there will be no tax charged thereon.

### 7.3 Does Sri Lanka have “controlled foreign company” rules and, if so, when do these apply?

There are no such rules in force at the moment. However, it should be noted that in the case of a foreign company, if the control and management of its business is exercised in Sri Lanka, such company would be deemed to be resident in Sri Lanka for the purposes of the IRA.

## 8 Taxation of Real Estate

### 8.1 Are non-residents taxed on the disposal of real estate in Sri Lanka?

There is no special taxation on the disposal of real estate in Sri Lanka by foreigners. The general laws under the IRA would apply. Given that there is no capital gains tax in Sri Lanka, non-residents would only be taxed to the extent that the profit from disposal amounted to a trading profit, i.e. accruing from a business of the non-resident of buying and selling properties in Sri Lanka.

However, please note the transfer taxes referred to in question 2.5 above in relation to taxes payable when land is transferred or leased to a non-Sri Lankan.

### 8.2 Does Sri Lanka impose tax on the transfer of an indirect interest in real estate located in Sri Lanka and, if so, what constitutes an indirect interest?

Sri Lanka does not impose tax on the transfer of an indirect interest in real estate located in Sri Lanka.

### 8.3 Does Sri Lanka have a special tax regime for Real Estate Investment Trusts (REITs) or their equivalent?

Sri Lanka does not have a special tax regime for REITs or their equivalent.

## 9 Anti-avoidance

### 9.1 Does Sri Lanka have a general anti-avoidance or anti-abuse rule?

There are provisions in the IRA that empower Income Tax Assessors to disregard transactions or dispositions which, in their opinion, are artificial or fictitious and reduce or have the effect of reducing the tax payable by any person, and to make assessments accordingly.

### 9.2 Is there a requirement to make special disclosure of avoidance schemes?

No such requirement exists.



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Naomal Goonewardena is a founding partner of Nithya Partners. He has multidisciplinary qualifications in law and finance and is a leading attorney in financial and tax law in Sri Lanka. He advises companies from various industries on all aspects and types of taxation, especially income tax and VAT. He also represents companies in litigious tax matters.

Prior to joining the firm, he was a Senior Tax Manager at Ernst & Young. He has also been a lecturer in Tax Law at the Sri Lanka Law College since 2003. Furthermore, he is a member of the Committee of Taxation of the Ceylon Chamber of Commerce. He served as a legal advisor to the Board of Review of the Inland Revenue Department from 1998 to 2002.



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Sheranka Madanayake, also with a multidisciplinary background of law and finance, joined Nithya Partners in January 2010 after completing her legal studies. She is attached to the corporate division of the firm and handles commercial matters including mergers and acquisitions, debt markets and project finance. She also assists in tax matters and has been involved in corporate and personal tax structuring and advising, transfer pricing and assisting in litigious tax matters.



Nithya Partners was established in 1997 with the goal of delivering a modern and responsive service in corporate and financial law. The firm's practice primarily focuses on corporate and financial law and we advise a broad range of local and foreign clients comprising several quoted and unquoted companies, multinationals, financial institutions, investment funds and statutory bodies. Apart from our involvement in some of the largest mergers and acquisitions and corporate restructurings in Sri Lanka in recent times, we have also played a lead role in several loan syndications, debt structurings and securitisations.

The firm's tax practice is the strongest amongst the legal firms in the country and we have consistently been ranked as the No.1 firm for tax in Sri Lanka by The Legal 500 and the Tax Directors Handbook. The firm has a strong reputation for corporate tax planning expertise, advising clients on complex tax disputes and tax efficient structures, and has acted on behalf of clients in a number of high-profile tax cases.

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