

8. Sources of Income other than from Trade, Business.....

8.1 Interest Receivable

Interest is a source of income which is chargeable with income tax.

Sec 3(e)

Income from interest is the full amount falling due, (the gross amount) whether received or not without any deduction for expenses and outgoings except in the case of a money lending business where the interest is treated as profits from a trade or business and not as interest income *Sec 25(e)*

In cases such as fixed deposits, treasury bills where interest is payable on fixed dates, it is treated as arising on such dates and assessed in the year of assessment in which it is received.

Where interest is received from outside Sri Lanka, the net amount received after deducting tax payable abroad on that income will be treated as interest income. If there is a relief due under the Double Tax Treaties, then the gross amount will be treated as interest income.

Where interest on a loan has not been received and is likely to be irrecoverable, such interest will not be treated as income. Any such amounts are received subsequently, it will be treated as income.

Where an assessment has been made including interest that is subsequently found to be irrecoverable, such assessment could be revised and such excess tax paid is refundable. The claim for the refund should be made in writing within 3 years of the end of the year of assessment in which the payment was made.

The following interest received by a person or partnership are exempt from income tax

- (a) Interest accruing on moneys in a Special Account in a Commercial Bank, opened with the approval of the Central Bank for deposit of sums obtained by the exchange of foreign currency held outside Sri Lanka; *Sec 9(c)*

- (b) Interest accruing on moneys lying in foreign currency with any foreign currency banking unit; *Sec 9(g)*
- (c) Interest accruing on moneys deposited in a Non-Resident Foreign Currency Account (NRFC A/c) or Resident Foreign Currency Account (RFC A/c) opened with the approval of the Central Bank; *Sec 9(d)*
- (d) Interest accruing to any person from any Security, Note or Coupon issued by the Government in respect of an approved foreign currency loan; *Sec 9(b)*
- (e) Interest accruing to any person on moneys invested in Reconstruction Bonds issued by the government of Sri Lanka denominated in United States Dollars (US\$); *Sec 9(e)*
- (f) Interest up to Rs. 500,000 from any deposit scheme in National Savings Bank, Bank of Ceylon, Peoples Bank, Saving Bank, State Mortgage and Investment Bank, Housing Development Finance Corporation Bank of Sri Lanka, SME Bank Ltd, Lanka Puthra Development Bank Ltd, or any bank established under the Regional Development Banking Act, No. 06 of 1997 or any Registered Coperative Society, by a Sri Lankan of over 59 years of aged (**Senior Citizen**); *Sec 9(h)(A11)*
- (h) The interest accruing from any money deposited in any Treasury Bond Investment External Rupee Account. *Sec 9(k)(A07)*
- i) Interest accruing to an **individual** from a Sri Lanka Nation Building bond in foreign currency issued by the government *Sec 9(i)*
- j) the interest accruing or arising from any investment made outside Sri Lanka to any person resident in Sri Lanka, where such interest is remitted to Sri Lanka through a bank. *Sec 9(n)*.
- k) the interest or discount arising or accruing to any non-resident citizen of Sri Lanka, from the purchase of any Motherland Development Bond denominated in foreign currency and issued by or on behalf of the Government of Sri Lanka; *Sec 9(m)*
- l) Interest accruing to any **company, partnership or other body of persons outside Sri Lanka** from a loan approved by the Minister

as essential for the economic development of the country, granted to the government or any public corporation, or government institution, or commercial bank, or any other undertaking.

Sec 9(a)

- m) in the case of non-resident persons or any licensed commercial bank in Sri Lanka the interest income arising on and trade profits from the sale of Foreign Currency Savings Bonds issued by the Government of Sri Lanka is exempt .

Interest received by a person other than a company.

Where interest on which withholding tax is deducted is received by a person other than a company such interest is not included in the assessable income of the person and the WHT so deducted is treated as final tax.

Credit or refund in respect of the WHT deducted is due only if the corresponding interest is included in the assessable income.

Where interest is received without deduction of WHT, such interest will form part of the assessable income.

Interest Income - Companies

The **gross** amount of the Interest received by a company on any deposit in a bank or financial institution from which withholding tax of 10% has been deducted or not as well as other interest received is liable to tax except those listed above which are exempt from tax. The withholding tax so deducted can be set-off against the tax payable by the company.

Where a company is engaged in any secondary market transactions involving Treasury Bonds, Treasury Bills and other Government Securities where a 10% withholding tax has been deducted, such person is entitled to a notional credit calculated at 1/9th the net amount received. The notional credit will then be 10% on the gross amount if the gross amount is included in the statutory income of the company.

In the case of a company engaged in primary or secondary market transactions involving any corporate security issued by a company and tax has been deducted at 10%, then the notional credit is available as in above.

Where a notional tax credit is claimed against the income tax payable and , if there is an excess, such excess can be carried forward to be set off against any future income tax liability but the excess cannot be refunded.

'Financial Institution' means any person or body of persons, corporate or unincorporate, whose business or part of whose business consists in the acceptance of money by way of deposit or loan in the form of debenture, bond or in any other

form and the payment of interest thereon, whether such acceptance is on its own behalf or on behalf of any other person. *Sec 147*

Distinction between profits and income of a trade or business and income from investments.

The Act provides that the income arising from interest shall be the full amount of the interest, whether received or not, without any deduction for outgoing or expenses. *Sec 25(4)*

However, in the case of a business of money lending, or where investment is carried on as a trade, the interest received is treated as trade or business income and all outgoings and expenses are deductible and the prohibitions of deduction from interest do not apply.

Considerable difficulty arises in deciding whether the income from dividends, interest or discounts is the profit from a trade or income from investments. This will have to be decided having regard to the facts of each case.

The following guidelines may be used in such instances-

- .If the business consists of the receipt of dividends, interest or discounts alone, or the business of receiving dividends can be clearly separated from the rest of the trade or business, then any special provisions applicable to dividends, interest or discount can be applied
- The nature of the trade must be carefully examined to ascertain whether an integral part of the business is the making or holding investment thus establishing a strong link between the investments and the liabilities to be met.
- Whether income from investments held by a business is trading income must ultimately depend upon the nature of the business and the purpose for which an investment fund is held.
- Making a series of purchases and sales of investments, if carried out pursuant to a deliberate and organized scheme of profit-making, may amount to a trade. A temporary course of investment of moneys surplus to current requirements may amount to a separate trade depending on the facts of each case.
- Where a trader keeps money invested for a long period of time, then it may be considered as investment but on the other hand if a

trader has invested in an interest bearing account to meet current short-term trading liabilities, the interest may not taken as income from trade.

8.2 Dividends received

A dividend is a distribution of profits by a company to its shareholders in the form of -

- a .(i) *money or an order to pay money*
- (ii) *shares in any other company, or*
- (iii) *debentures in that company or in any other company*
- b. *the amount of capital returned or distributed to the extent of the paid up value of any bonus shares within six years from the date of the issue of bonus shares by capitalization of profits*

A dividend includes scrip dividends *-Budget 2012*

A dividend will not include a bonus share or a payment in reduction of capital other than in the circumstances stated above.

Dividends received by a person other than a company

Where a person other than a company receives a dividend and tax at 10% has been deducted under Section 65(1), the tax so deducted is considered as the final tax provided the dividend is not received as income from a trade or business.

Such dividend will not form part of the assessable income of the person and no tax credit can be claimed.

Dividends received by a company

The following dividends received by a resident company not as income from a trade or business. (*i.e. not trading in shares*) are not liable to tax –

- Dividends received from another resident company after deducting tax at 10%
- Dividends which are exempt under Sec 10.
- Dividends declared by a resident company out of dividends received from another resident company
- Dividends received from a quoted public company

The following dividends received by such company are liable to tax-

- Dividends received from outside Sri Lanka *(Sec 55)*
(Dividend to be taxed at 10% subject to Double Taxation Relief)

Dividends declared out of the qualified export profits which have been subjected to tax and which are received by a company trading in shares, included in its taxable income, are liable to tax at 10%. Sec 53(3)

Deductions in respect of expenses and outgoings are **not** allowed unless the dividends are received in the course of trading in shares.

8.3 Rents received by companies

Rent received by a company from letting or leasing of premises and any land by a company is treated as business income and not as income from rent. Any other rent received will be treated as income from rents for companies

Note: *By definition, business includes letting or leasing of premises and any land by a company*

8.4 Royalty received.

Royalty received from outside Sri Lanka will be exempt from tax, if remitted to Sri Lanka through a bank. *Budget 2012*

8.5 Charges and Annuities

(a) Charge

A charge is a sum received by a person under a deed or an order of Court which is secured on the income or property of the payer.

(b) Annuity

There is no definition of annuity in the Act. Generally an annuity is a fixed sum received annually either in perpetuity or for some less period and is not of a capital nature.

A contract to pay an annuity may be entered into for valuable and sufficient consideration or for the life of an annuitant.

The above definition covers-

- a. Purchased annuities
- b. Annuity by covenant.

(a) Purchased Annuity

“An annuity means where an income is purchased with a sum money and the capital has gone and has ceased to exist, the principal having been converted into annuity”

Annuity usually involves the purchase of income by payment of a capital sum. Although the annuity received is partly of the capital sum paid, the payment would be in the nature of income as the capital has ceased to exist.

(b) Annuity by Covenant

The ordinary meaning of annuity would include a payment made under a legal obligation which the person had voluntarily taken upon himself without any consideration received from the payee provided the payment was made with reference to any year and had the character of pure income in the hands of the payee.

Examples of annuities are-

- (i) amount payable to a under a court order e.g. maintenance, alimony
- (ii) payment to a widow under a court decree
- (iii) payment to a retired partner or to the estate of a deceased partner by way of annual payments.
- (iv) purchase of an annuity from an insurance company.

Whether a particular sum has been paid out by way of an instalment of capital or whether it is a payment in the nature of an annuity has to be determined on the facts.

CL8.1 *J.M. Rajaratnam v CIR (3 CTC 378)*

“For a payment to be an annuity it must-

- (1) be made with reference to a year though it may be paid in periodic instalments e.g. quarterly or monthly;
- (2) not be a receipt or accrual of a capital nature to the payee
- (3) be made under a legal obligation;
- (4) be either recurrent or capable of recurrence;
- (5) be pure income of the payee.”

Chargeable with tax

The full amount of the charge or annuity received by a person is income liable to tax without any deduction for any outgoings or expenses.

However, in practice, in dealing with annuity for a fixed number of years only the interest portion is taken as income.

Where a person has purchased an annuity for a fixed term from an insurance company, the division between capital and revenue can be obtained from the company. The interest portion will be liable to tax.

Exemption to individuals

Any annuity accruing to an individual whose age is 60 years or more, being an annuity for life or for a period not less than 10 years, purchased

from a bank or an approved insurance company for full consideration in money or moneys worth paid for the purchase of the annuity, is exempt from tax.

Withholding tax on annuity payments

Any annuity payment which exceeds Rs.50,000 a month or Rs.500,000 in any year is liable to a WHT of 10% on the gross amount.

In the case of annuity paid to a person or partnership outside, the rate of WHT is 20% or such other rate as may be directed by the CGIR, subject, however, to any Double Tax agreement that may exist.

8.5 Royalties

Royalties are payments received as consideration for the use of, or the right to use, any copyright, patents, trade mark, know-how etc.

8.6 Premiums

Premiums are payments received as a consideration for obtaining the right to use a property rather than for the actual use of the property.e.g. Key money received on letting a house. (Refer Chapter 3.4 Miscellaneous)

8.7 Winnings from Lottery, Betting and Gambling

Sec 157

Profits and income include Winnings from Lottery, Betting and Gambling and are chargeable with Income tax.

Sec 3(h)

Withholding tax at 10% is required to be required at the time of making payment where such payment is not less than Rs.500,000. The withholding tax deducted operates as the final tax on the winnings. The assessable income of a person shall not include such winnings on which the tax due has been deducted.

Sec 32(3)(b)

The part of the taxable income of a person or partnership as consisting of the profits and income from the business of any lottery or betting and gambling carried on or exercised by such person or partnership is liable to income tax at 40%.

8.8 Income from other Sources

Income from any source whatsoever, other than those specified in the Act excluding profits of a casual and non-recurring nature is made liable to tax

Illegal trading such as illicit felling of trees, illegal brewing, smuggling, providing illegal automatic gambling machines are assessable to tax.

This is 'catch-all' clause intended to bring into charge income which is not caught up in the other sections of the Act which has the characteristics of income liable to income tax.

8.9 Alienation of Income

The general principle is that income is assessed on the person who is the legal owner of the source of income. Income cannot be assigned without alienating the source itself.

" If a person has alienated or assigned the source of his income so that it is no longer his, he may not be taxed upon the income arising after the assignment of that source." - The Law and Practice of IT by Kanga and Palkivalla

Income from services assigned, and in any manner whatsoever, will not be effective against revenue.

There are three exceptions to the general principles-

1. Where there is a diversion of income by overriding title.
2. Where the income is dealt with by some other person as if it his own.
3. In relation to embezzled funds received through a mistake of fact.

The test laid down by Hidayatullah, J. in *Commissioner of Income Tax v. Sitaldas Prathdas* "reads as follows:—

"In our opinion, the true test is whether the amount sought to be deducted, in truth, never reached the assessee as his income. Obligations, no doubt, there are in every case, but it is the nature of the obligation which is the decisive fact.

There is a difference between an amount which a person is obliged to apply out of his income and an amount which by the nature of the obligation cannot be said to be a part of the income of the assessee. Where by the obligation income is diverted before it reaches the assessee, it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow.

It is the first kind of payment which can truly be excused and not the second. The second payment is merely an obligation to pay another a portion of one's own income, which has been received and is since applied. The first is the case in which the income never reaches the assessee, who even if he were to collect it, does so, not as part of his income, but for and on behalf of the person to whom it is payable."

8.10 Diversion of Income by over-riding title

By way of illustration, the decision of the Privy Council in the case of *Raja Bejoy Singh Dudhuria v. Commissioner of Income Tax, Bengal.*"

The appellant (assessee) in this case had succeeded to ancestral property on the death of his father. His step mother – sued him for maintenance and a consent decree was entered by court declaring that the lady's maintenance was a legal liability of the appellant and that this maintenance was a charge on the ancestral estate in the hands of the appellant.

The appellant had paid the lady a sum of Rs. 9,900 in terms of the decree in the year of assessment 1924-25 but this was taxed on his income and no deduction was allowed. In allowing the appeal and the deduction claimed the Privy Council said:–

"In the present case the decree of the court by charging the appellant's whole resources with a specific payment to his step-mother has to that extent diverted his income from him and has directed it to his step-mother; to that extent what he receives for her is not his income. It is not a case of the application by the appellant of part of his income in a particular way, it is rather the allocation of a sum out is revenue before it becomes income in his hands."

This is a case where by virtue of a decree the assessee was compelled to allow a part of his income to be diverted to his step-mother - a clear case of diversion by overriding title.

Miscellaneous

Royalties for copyright.

It is a settled principle that the pecuniary rewards derived by an author from his literary labours are income.

But when a writer has the copyright it is an asset in his hands.

If he allows it to be used by another person, usually a publisher, the payment he receives per copy is undoubtedly income (royalty)

If he sells it outright-

- (a) If the sale takes place while the author carries on his profession, the sum received is normal income from profession.
- (b) If the copyright is sold after the author has ceased to carry on the profession the receipt is a capital sum.