"BRIDGING THE INCOME GAPS FOR REVENUE": A STUDY RELATING TO RE-INTRODUCTION OF CAPITAL GAIN TAX IN SRI LANKA

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ABSTRACT

The re-introduction of Capital gain tax (CGT) under the new Inland Revenue Act No.24 of 2017 (IRA) of Sri Lanka lead to many debates among policy makers, tax professionals, academics since on how CGT has a serious impact on the economy of the country. It is widely believed that taxes on capital gains will slowdown the economy growth of the country and foreign investment. On the other hand, it is authoratively argued that CGT is a perfect tool to reduce the gap between rich and the poor. Therefore, the main objective of the study is to critically analyze the provisions relating to CGT under the new IRA in order to ascertain reasons behind re-introduction of CGT which was abolished in 2002. Another objective is to examine the challenges the CGT imposition pose on the economic development of the country. The question arises whether the re-introduction of CGT is bridging the income gap between the two in-equal groups and increase the economy of the country. To answer this question the research focuses to analyze as to how far the CGT adheres to the well know taxing principle of reducing the inequalities through redistribution policy. The research also investigates the extent to which such type of tax promotes formation of capital for the development of the economy. The administration of all forms of direct taxes poses a challenge to tax administration in developing countries. This is because if the tax administrating authority follows strict compliance mechanism to collect taxes, it will cause huge hardships to a tax payer with average or lower income. Less developed countries are heavily relying on indirect taxes. Therefore, this study examines that due to the difficulty inherent to the tax administration, whether this new measure would achieve its objective of generating significant amount of government revenue. The study will suggest to the policy makers the best mode to maintain a balance between investment friendly environment and revenue generation while taking into consideration that the economic development of the country is not to 'un-lock capital' for new investment. The study is qualitative in nature, while minor quantitative method is used involving data gathering from primary sources, including those of tax experts and tax payers.

Keywords: Capital gain tax; Direct and Indirect taxes; Gains; Realization

INTRODUCTION

Tax plays an important role in both government and private sectors, especially for the regulation of profits and income of every person for the economic development of the country in general and upgrading the living standards of the people in particular. Tax is the money raised and collected by the government for the government expenditure. The government revenue is collected by way of taxation is intended to be used to meet the development programmes and strengthen the country's potential. Taxes are considered as primary source of income of the government to expand the welfare of every single citizen. All expenses of the government met by collecting taxes in different forms from the general public. The efficiency of the taxation system of a state is primarily judged by whether the government sufficiently utilizes the public funds for benefit of the public and wellbeing of citizens.

Under a less complex social system than that which we know today, the government expenditure could be satisfactorily supplied by collecting tax of certain sum from each person with in the country of the taxing authority. The simple poll tax is no longer adequate. In order to meet the increasing expenses of modern fiscal planning, it is important to adjust the amount to be collected on each individual by means of variables which will take into account of fiscal necessity and economic policy and the ability of the individual taxpayer to contribute[1].

TAX REVENUE TO GDP

In a developing economy the main objective is to accelerate the tempo of economic development. Taxation is one of the major means to achieve the above objective. Fiscal legislations are the tools to collect revenue in various forms for the countries development agenda. The growth of Gross domestic product (GDP) is an indicator that the nation is getting richer and the people could pay more taxes. Nicholas Kaldor, a Cambridge economist argued that for a country becomes developed, it should collect taxes at the ration of 20-30 percentage of GDP.

While in Sri Lanka overall GDP as well as capital income has been steadily increasing over the years, government total revenue and tax revenue has been continuously decreasing. It is seen that total government revenue as a percentage to GDP has declined from 21.1% in 1990 to 11.4% in 2014 and tax revenue ratio has declined from 19.0% in 1990 to 12.5% in 2017[2]. Central bank report 2015 stated that the nation's revenue is not sufficient even to cover the maintenance expenditure of the government.[3] However, the proportion of tax revenue to GDP in other countries is very much high compared to Sri Lanka. In higher income countries the ratio is about 42% and middle income countries about 25-29%. This ratio in developing countries is about 20%. In

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[1] Par J.V. O'Donnell Jr ; Income and Capital Gain

[2] https://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS?locations=LK&name_desc=true; Accessed on 09th May 2019

[3] P.172

2012 the government of Sri Lanka has projected to increase the tax GDP ratio into 19% but unfortunately it was not achieved as projected until now.

Every one aware that Sri Lanka has heavily borrowed from foreign sources and to stabilise its source of funds, more revenue should be generated from taxation to meet expenditure as opposed to debt. It is argued that the current tax system is not delivering the potential revenue in Sri Lanka. The key reason for this is that the tax base has not broadened in line with the increase in income or economic activities. The reason for the weak tax base is the multitude of tax exemptions, tax evasion, many discretionary tax measures in operation, and weak tax administration. Therefore the tax on 'gains' in addition to current system of collection of income tax from profits and income is a better tool to increase the Tax to GDP ratio and government revenue to meet state expenditure. The policy makers are in the opinion that CGT is an appropriate tool to eradicate the possible practise leads to tax avoidance and evasion. Particularly, the wealthy community in the society is deriving economy from certain well-income business activities such as real estate and condominium. Therefore, it would be reasonable to collect additional taxes from them rather than imposing more on an average citizen.

DIRECT AND INDIRECT TAXES

The fundamental classification of taxes is based on the body that who collects from the payer. While direct taxes are paid directly to the government by the taxpayer , indirect taxes are applied on manufactures or sale of goods and services which are initially paid by intermediates who adds the amount paid to the value of goods or service hence ultimately the consumer should bear the tax. Whether a rich or poor consumer buys commodities, the price in the market is same for all consumers because the taxes are included in the price. Thus the rich and poor pay the same amount, which is obviously unfair. [4] If the indirect taxes are imposed on luxury items or the commodities used by the richest community, they are equitable as those goods are not considered as primary goods.

Government should collect the revenue by taxing the people, particularly those who are in a position to pay taxes. One of the main distortions in Sri Lankan economy is that indirect taxes are very much high than direct taxes.[5] It is noted that Direct tax to Indirect tax ration of Sri Lanka is an inequitable 19:81 hence the source for additional taxes required to the government should not be from indirect taxes. The ratio should be where 60% of revenue should come from direct tax while 40% must come from indirect taxes. However, as per 2017 performance report of Inland Revenue, around 75% of the tax revenue is gathered from indirect taxes.

The amount of indirect taxes paid is invisible in Sri Lanka therefore the public unaware of the fact that what the poor community of the nation paid as taxes for government revenue. Wealthy community wrongly believed that they bear the tax burden as they pay a high amount of income taxes. Thus the encomiastic are suggesting to moving towards the direct taxes based on every individual's earnings and overall economic position. Through direct taxes a government can have well-defined tax slabs and exemptions in place so that the income inequalities can be balanced out.

RATIONALE OF CAPITAL GAIN TAX

The important function of taxation is to reduce the inequalities through redistribution policy. The equality principle in taxation implies that revenue should be imposing according to the ability to pay. If the capital gains are not taxed, certain individuals and group will receive a preferential treatment over others which will undermine the progressivity of tax revenue. Further CGT, prevents misallocation of resources and minimise the opportunities for tax avoidance.

CGT will help to decrease the unnecessary tax burden on consumers who might otherwise required to pay a high amount of tax in the form of VAT, NBT , Excise duty etc which affect the poorest of the poor rather than wealthy community. Generally, transactions relating to real estate, condominium, membership interest in a company and other financial assets are taking place among the rich community. In such context, charging CGT is comparatively a better source of income to the government rather than increasing other forms of taxes, which will cause more burdens on an average consumer.

In 2017, during his speech on budget allocation of the country the former Finance Minister of Sri Lanka Ravi Karunanayake proposed a revised system of taxation of the country. He suggested a simpler tax regime with minimum tax exemptions and a broadened tax base. The Capital Gain Tax (CGT) was suggested to reintroduce into the existing taxation at the rate of 10%. It was argued that this tax to be equitable as it will bridge the income gap among the stake holders and assist the government initiatives in poverty alleviation. Accordingly the new Inland Revenue Act has imposed a CGT on the gain from the realization of an asset with effect from 1st day of April 2018.

HISTORY OF CGT IN SRI LANKA AND REASON FOR THE ABOLITION

The tax on capital has been a feature of the tax system of Sri Lanka for several years and has taken many forms. The CGT has been existence in Sri Lankan from 1950s under various statutes of the country. Tax on immovable property levied in the form of land tax for two years from 1960. In 1971 immovable property was included in the capital levy. Estate duty was applicable since

[4] http://www.sundaytimes.lk/180325/business-times/inequality-of-the-sri-lankan-tax-system-287110.html ; accessed on 09th May 2019

[5] http://www.sundaytimes.lk/171217/business-times/indirect-taxes-have-overtaken-direct-taxes-in-the-country-273058.html ; accessed on 09th May 2019

1919 and it was abolished in the year 1985. Taxation on capital gains was introduced as part of the Kaldor Reforms in 1957 and it last until the year in 2002.

The CGT was imposed under sec.7 of the Inland Revenue Act No.38 of 2000 and it was lasted until 2002. Under the above law change of ownership of any property and gains from certain transactions such as surrender or relinquishment of any right in a property were considered as capital gain. Therefore, immovable and moveable properties were subject to be liable for CGT. The formation, dissolution and amalgamation or merger of companies or businesses was liable to CGT. The law provided certain exceptions for each gain. Under the old laws, the rate of the CGT was depending on the period of ownership held by the owner. The shorter period of ownership leads to higher the rate of the tax.

The rate varies depending in the period of ownership. While the ownership duration held in possession for more than 25 years was exempted from CGT, the period of ownership less than two years was treated as a trading income and it was taxed at the normal tax rates. It is submitted that there were several tax exemptions under old law with regard to CGT and such exemptions have not been taken into consideration when drafting new act.

Table 1: Rate of Capital Gain Tax under the Act No.38 of 2000

Period of Ownership of Property	Rate
02- 05 years	20%
05-15 years	17.5%
15-20 years	12.5%
20-25 years	5%

There are several reasons for the abolition of such tax under the previous laws. The main reason for the abolition in 2002 was to promote investment and for the economic development of the country. Due to inadequate revenue to run government there was a need to attract investors from both foreign and domestic levels. The main reason is the government was able to collect less amount of revenue through CGT. There are certain difficulties in administrating CGT which resulted in insufficient revenue collection of the country. Abolition of CGT has result on un-locking of capital for new investors.[6]

RATIONALE BEHIND THE RE-INTRODUCTION

The imposition of income tax on gain is a form of direct taxation. Therefore the reason behind re-introduction of capital gain taxes (CGT) which was abolished from 2002 is to increase the volume of direct tax. The intention of the legislature is revealed from parliament debates that one segment of the community is deriving benefits from real estate in Sri Lanka, including land and condominium properties; therefore it would be equitable to collect taxes from this group of community.

The available data of the Inland Revenue Department witnessing that in recent time the revenue as a percentage of GDP has been on remarkable decline over a long period of time. This leads to a serious concern for the authorities responsible and accountable for economic management and development of the country. Therefore an attempt is made to examine the key elements of the capital gains regime in order to determine its impacts on the current legal system. It was found that when the CGT was in force under the previous laws, it amounted to 1.1 percent of the total tax collection of that particular year.[7] Therefore it should be noted that CGT was abolished in the year 2002 and this amount able to be taxed from CG source of income for a period of 16 years in the country.

The chapter IV of the new Inland Revenue Act No.24 of 2017 re- introduced the provision imposes "Gains from realisation of assets and liabilities" with income tax, hence, it is noted that no new form of called CGT adding to the number of taxes in Sri Lanka. Initially it was proposed to re-introduce CGT at the rate of 10% on immovable properties, But the concept has be legislated in the Act in wider manner. The income tax on gains introduced to impose is not restricted to immovable property but extends to all types of assets including immovable, movable, tangible and intangible etc. As a result, gains from unlisted shares and other types of financial benefits will be liable. Further, the tax is applicable on gains from liabilities in addition to assets. Therefore, debts and loan benefits also will be liable to CGT. However it is noted the income tax free status is continue to apply for the sale proceeds of listed shares under the new Act.

NEW CAPITAL GAIN TAX (CGT)

The Inland Revenue Act No.24 of 2017 (the new act) provides that capital gains arise from the realization of an asset or the sum of the consideration received or receivable for the asset or liability exceeds the cost of the assets or liability at the time of realization[8]. The capital gain will be the result of sale price less the price of purchase. In addition, expenditure on advertising,

[6] Suresh R.I. Perera, LLB, Attorney at Law, FCMA (UK), Tax expert (interview by Daily FT on salient points of the new Capital Gains Tax which comes into force April 2018 and its impacts on 2nd April 2018) (http://www.ft.lk/financial-services/All-you-need-to-know-about-the-new-capital-gains-tax-from-April%C2%A02018/42-652536)

[7] Administrative Report of Inland Revenue Department, 1997.

[8] Sec.36 of Inland Revenue Act No.24 of 2017

transfer taxes, stamp duties, chargers imposed for establishing, preserving or defending ownership of the asset and remuneration for the services will be allowed to be deducted from capital gain[9].

The new Act clearly defined the terms such as capital assets, cost of assets, realization of assets and consideration for the purpose of calculating CGT. The cost of the asset will be allowed to deduct from the price of purchase. This cost includes the expenditure incurred in acquiring the asset such as construction, manufacture or production of the asset and expenditure of altering, improving, maintaining or repairing the assets. It further includes the incidental expenditure in acquiring and realizing of an asset. Under the Act the term realization means that a person parts with the ownership of the asset, including when the asset is sold, exchanged, transferred, distributed, cancelled , destroyed , expired or surrendered. It is important to note that under new Act the CGT is taxed at a flat rate of 10 percent, irrespective of the period of ownership held by the owners of the asset.

The general rule under the new act grants a special relief in relation to the principle residential house of an individual. The transfer of principle residential house owned by the individual continuously for the three years immediately before disposal by the person would not attract the tax provided it has been occupied by the individual continuously for at least two of those three years (calculated on daily basis)[10]. This relief is restricted to the houses fulfilling above requirement.

In addition to the general rule there are special rules enacted under the Act. There are certain gifts by individual may not be tax when the donor transfers it to a special category of donee such as charitable institutions. Transfer of properties by parents to children is subject to special rule. The Act makes a special provision in relation to residential individual where a gain from realisation of an investment asset is less than Rs.50, 000 a month or Rs.600,000 per annum will not be liable to tax on realisation[11].

Apart from the reliefs, there are a few exemptions under the Act. The trading stocks or depreciable assets are not treated as realization of an asset for the purpose of CGT. Transfer of assets from one spouse to another in a bona fide separation and realization of an asset on a death of a person are a few exemptions, in which CGT will not arise.

CHALLENGES IN ADMINISTRATION OF CAPITAL GAIN TAX

Under the new Act, the gain is calculated as the consideration received for the asset or liability exceeding the cost of the asset or liability at the time of realisation[12]. Hence, the challenge is to ascertain the cost base with evidence. The Act provides for certain adjustments to be made to the cost and consideration received for assets. Costs includes the expenditure of incurred acquiring, altering, improving, maintaining or repairing the asset and the incidental expenditures such as legal and litigation cost, advertisement cost, etc. However evidence to prove for these adjustments will cause a challenge to the tax administration body. In addition, the voluntary compliance of the taxpayers is an essential factor to trace and investigate isolated transactions giving rise to gains.

Another difficulty is from the perspective of policy to tax “Gains from assets and Liabilities” it’s nothing but equitable that only the Gains or appreciations occurring after the introduction of the new law should be taxed. Appreciation occurred and attributable to the holding period before the introduction of the new law should not be taxed[13]. Nevertheless, the law makers seems to have attempted to achieve this equitable status through section 203(4) which provides that the cost of an investment asset held by a person as at, September 30, 2017 is equal to the market value of the asset at that time.

Capital gain is meant an increase or growth in the income-producing object, usually realized or realizable in monetary value. The confusion arise here is that the object considered as capital may itself become the subject of a trade and take on an income nature. The person who formerly sold the property may decide that there is profit to be made by venturing into the selling of it. This principle was confirmed by a judicial decision of Canada. Lord Macmillan in the Privy Council Judgment in *Spooner V. M.N.R*[14] was of the above opinion,

> *“It is necessary in each case to examine the circumstances to see what the sum really is, bearing in mind the presumptions that it cannot be taken that the Legislature meant to impose a duty on that which is not profit derived from the property but the price of it”.*

Therefore it is submitted that the identification of the nature of gain might be an issue for the tax administrators for the effective implementation of CGT. Therefore, there are a few possibilities to seek clarification from the judiciary in near future in this regard.

[9] Sec.37(4) Inland Revenue Act No.24 of 2017

[10] Sec.195 of Inland Revenue Act No.24 of 2017

[11] Para (f) of Third schedule of the IRA No.24 of 2017

[12] Sec.36 of Act No 24 of 2017

[13] http://www.ft.lk/financial-services/All-you-need-to-know-about-the-new-capital-gains-tax-from-April%C2%A02018/42-652536 ; Accessed on 25th of May 2019

[14] 1933 AC 688 (The Meaning of Income Tax in the Law of Income Tax)

THE ARGUMENTS ON CGT

It is widely believed that taxes on capital gains will slow down the economy growth of the country. But on the other hand it can be argued that CGT is a perfect tool to reduce the gap between rich and the poor. Ordinary individuals for the purpose of this tax can be analysed from two fronts. The individuals who entering into business transactions in the course of business on one front and individuals not engaged in any trade activities but deriving gains from private or investment assets on the other hand. Since the law provides that CGT is payable on "Realization of gains" the impacts is not only for the individuals who are selling their private properties but also for those who are entering into transactions in the nature of gift and donations. The concept of realisation is not merely includes parting of ownership but change in status of assets, liquidation of company and death of a person, change in the status of residence and write off bad debts as well.

The newly introduced CGT is not complicated and it has one flat rate of 10 percent. However, such a flat rate will cause unfair to the long term ownership without money making intention compare to short term investors whose main intention is to get investment income. This may cause inequalities among the stake holders. Since one of the main reason for re-introducing CGT is to bridge the income gaps of the society, levying a flat rate for all types of retaliations without considering the period of ownership or the reason behind the realisation will cause negative impacts on the individuals who owns a property for generation or who received a property from his forefathers. It is therefore suggested that it will be more beneficial to have rates various depends on the period of ownership as in the previous laws.

It is argued that the administration of direct taxes is comparatively difficult and causes a challenge to the tax administrative body in almost all jurisdictions particularly in developing countries. On the other hand indirect taxes are easy to administer by the authorities. Therefore, the countries with less developed tax administrations are heavily reliance on indirect form of taxes which they can impose with the consumption of goods and services. It is noted that direct tax to indirect tax ration of Sri Lanka is not only a result of the tax policy of the country but also due to weak and inefficient administration of the authorities on direct taxes.

The tax collecting authorities are not functioning in an active manner to collect taxes and to find out the tax failures by the payers. The revenue laws and collecting officers should ensure an Assessee- friendly implementation when they are collecting taxes. Law is not good as it is enacted, but only as good as it implemented. Good law implemented with assessee-friendly approach, rather than strict compliance mechanism which would cause hardships to tax payer who prefers voluntary compliance of law. The authorities should adopt certain effective mechanism to collect CGT with less difficulty with voluntary compliance. Therefore it can be argued that due to such ineffective administration of direct taxes it is doubtful whether the CGT would generate any significant quantum of revenue.

Inland Revenue Department may not be in a position to evaluate the actual impact of as only tax from realisation of investment assets that may be recorded as opposed to tax on gains from capital assets which would be a part of the annual income tax. Further, the Act provides that a person disposing of a capital asset should be required to file a CGT return within one month after the realization of the capital asset. Thus, CGT tax is imposed on a transactional rather than periodic basis. Consequently, a separate return must be file in respect of each transaction. These may cause further procedural difficulties and burden to Inland Revenue Department. The commissioner of Department will be under obligation to monitor the self-assessments by way of returns in transactional basic in addition to year end- assessment. In such a situation non-compliance with the law can easily occur unless the tax payer voluntarily complies with the law. If tax administration is in default stage, there might be a gap between what the government actually gets from taxes.

The experience from other countries such as India revels that the tax generated from tax on capital gains is not that great. Most of the investment friendly jurisdictions in the world are reluctant to tax on gains from capital. Most of the investors are willing to invest in a country which has liberal revenue policy on investment. The idea behind CGT is taxing a profit made from sale of property or financial assets which is the major concern of the invertors when they choosing where to invest and how to maximise their profit from the investment. Therefore paying CGT is discouraged investments and stop capital from reaching its highest value.

On this concern, The Revenue laws of Switzerland exclude CGT on gains from trading of securities and private properties. Singapore is offering competitive incentives for the investors and remains as low tax nation; hence there is no CGT in Singapore. Malaysia abolished CGT on real estate in 2007 and no CGT for the gains on equities. Nevertheless the taxing laws of Malaysia imposed a de facto capital gain in the form of "real property gains tax" on real estate. Non- residents who are holding the properties less than five years need to pay 30% withholdings on gains under this type of tax[15]. Therefore the leanings gain from other jurisdiction witnessed as Economists are arguing, the introduction of capital gains tax possibly would have a negative impact on short-term economic growth of a developing country like Sri Lanka.

CONCLUSION

No country can run its government expenditure with one type of tax. Direct and Indirect taxes must be mixed in a good system of taxation. In a good tax system there should be a proper balance between direct and indirect taxes. The revenue will be optimum and loss of incentives minimum. The imposition of income tax on Gains is the form of direct taxation which will be a potential tool to bridge the income gaps for government revenue of Sri Lanka to a certain extent in the long run.

[15] Malaysia Investment and Taxation 2018 https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-malaysiaguide-2018.pdf , Accessed on 10th May 2019

There has been many a reason put forward to support the inclusion of a CGT, chief among which is that the government's spending on infrastructure has massively helped raise the prices of real estate property and thus it is suitable for the government to also benefit off of such transactions. Therefore, The CGT will broaden the tax base and bring a considerable income to the state coffers while the CGT helps to ease unequal distribution of income.

However, simpler procedures should be adopted in order to enable the tax payer to distinguish the capital gain and gain from realization of a capital clearly and to ensure that the taxpayer does not face many complications. It is suggested to the policy makers to ensure a balance between investment friendly environment and revenue generation. The measures taken by the laws makers of the country will not 'un-lock capital' for new investment for sure.

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