Executive summary

On 20 November 2015, Sri Lanka presented its 2016 national budget (Budget 2016), which includes changes to the corporate income tax rate structure, several tax incentives for selected industries, the Economic Service Charge (ESC), Nation Building Tax (NBT) and Value Added Tax (VAT) rate changes. The Budget 2016 aims at accelerated development, encouraging foreign direct investment and creating the necessary conditions to promote local industry for greater employment opportunities. Unless noted otherwise, the proposed changes will become effective for taxable years beginning on or after 1 April 2016 for income tax and ESC amendments and 1 January 2016 for VAT and NBT amendments.

This Alert summarizes key features of the Budget 2016.

Detailed discussion

Corporate income tax

Income tax rate changes

The corporate income tax structure will be simplified by creating the following two tax rates:

- A 30% rate on income from: banking and finance including insurance, leasing and relating activities; trading activities other than manufacturing or providing services; and betting and gaming; liquor; tobacco. In addition, a 25% surtax will apply to the income tax liability imposed on the businesses of betting and gaming; liquor; tobacco.
- A 15% rate on all other sectors, mainly including all services, manufacturing and agriculture.
Deemed dividend
For companies listed on the Colombo Stock Exchange (CSE), the minimum amount of dividend distributed without triggering deemed dividend treatment will be increased from 10% to 15% of the distributable profits.

Dividends
Certain exemptions from tax on dividends provided after the end of the tax holiday period will be repealed. It is expected that the tax exemption on dividend income granted under certain agreements with the Board of Investment will continue.

Interest income
The interest withholding tax exemption granted currently to a nonresident person on the interest income from foreign loans given to a Sri Lanka resident will be repealed unless the nonresident person is a foreign bank or financial institution.

Tax incentives
A 50% tax liability
A reduced 50% tax liability on income from the following activities is proposed:

<table>
<thead>
<tr>
<th>Tax incentives</th>
<th>Incentive period</th>
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<tbody>
<tr>
<td>Income from the locally developed seeds and planting materials</td>
<td>5 years</td>
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<tr>
<td>Income from agriculture using drip irrigation, green house technology and high-yielding seeds. (Definition will be provided)</td>
<td>5 years</td>
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<tr>
<td>Income from the local manufacture of red clay tiles (thrust industries)</td>
<td>3 years</td>
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<td>Income attributable to the expansion carried out by modernization of existing factories based on increasing of employment within a one year period commencing from 1 April 2016</td>
<td>3 years</td>
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<td>Income from new company setup in any developing region with a minimum Investment of:</td>
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<td>US$10 million or 500 new employees</td>
<td>5 years</td>
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<tr>
<td>US$10 million or more than 800 new employees</td>
<td>8 years</td>
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<tr>
<td>Or</td>
<td></td>
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<tr>
<td>If the investment is for a theme park</td>
<td>10 years</td>
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</table>

Other tax incentives
- The current reduced 50% tax incentive for listing on the CSE before 1 April 2017 will be extended as follows:
  - Two years for listing on the CSE
  - Three years for listing on any foreign stock exchanges
- Withholding tax is exempt on dividends from listed shares received by nonresident individuals or foreign companies.
- A triple deduction for research and development expenses will be allowed, only if a technology advancement and yield development is proved. A triple deduction is also available for endowments given to National Universities to engage in research.

Tax administration
Refund
The Budget 2016 proposes that, for a refund claim for any year of assessment commencing on or after 1 April 2016, issuance of such refund should be made within three years from the claim shown on the return; otherwise, the refund would be credited against future tax liability.
Transfer pricing
Administration of the transfer pricing (TP) on domestic transactions will be simplified and the areas will be specified, limiting the scope. Penalty provisions will be introduced to ensure proper implementation of TP regulations.

ESC
Currently, a 0.25% ESC is imposed on the gross revenue of businesses exceeding Rs.50 million (US$ 354,000) per quarter, only if the businesses are under any tax exemption or are incurring tax losses. Under the Budget 2016, the applicable rate will be increased to 0.5% and will subject profitable businesses but repeal the maximum liability of Rs.120 million (US$851,000) per annum. The current five-year carry forward period of ESC will be reduced to three years, effective for taxable years beginning on or after 1 April 2016.

VAT
The Budget 2016 introduces the following rates, effective as of 1 January 2016:

- 0% (Zero rated) - applicable to the export of goods and services for foreign currency receipts.
- 8% (Standard rate) - applicable on the manufacture and import of goods.
- 12.5% (Higher rate) - imposed on the service sector. Banking and financial services would also be liable at the higher rate.

In addition, the gross revenue threshold to be liable for VAT (currently at Rs.15 million (US$106,000) per annum and Rs.3.75 million (US$27,000) per quarter) is proposed to be reduced to Rs.12 million (US$85,000) per annum or Rs.3 million (US$21,000) per quarter.

NBT
The rate of NBT is proposed to be increased from the current 2% to 4% from 1 January 2016 and the general threshold to be liable to NBT is proposed to be reduced from Rs.3.75 million per quarter to or Rs.3 million per quarter.

Other taxes
The Share Transaction Levy (STL) will be repealed effective as of 1 January 2016.

Endnotes
1. Currently, the standard rate of corporate income tax is 28%. Tax rates of 10%-40% apply to certain business activities.
2. A company that distributes dividends that total less than 10% of its distributable profits for the preceding fiscal year is subject to a deemed dividend tax at a rate of 15% on the difference between 331/3% of the distributable profits and the total dividend distributed.
3. The calculation of distributable profits is specified in the law.
4. Incentives are also offered to small and medium enterprises as well as other types of income.
5. In general, the corporate tax incentive will begin from the beginning of the tax year in which the company starts to have income from such activities, or any tax year not later than two years from the commencement of such commercial operation, whichever is earlier.
6. Currently dividends paid to any person including nonresident individuals and foreign companies are generally subject to 10% withholding unless specifically exempt.
7. Currently, NBT is chargeable at 2% from importers, manufacturers, service providers and retail/wholesale business on liable gross revenue of the relevant quarter. Certain exemptions for goods and services are available.
8. Currently, 0.3% STL is chargeable from both the buyer and the seller on the sale value of listed shares transacted through the CSE.
For additional information with respect to this alert, please contact the following:

**Ernst & Young LLP (Sri Lanka), Colombo**
- Duminda Hulangamuwa  +94 11 246 3500  duminda.hulangamuwa@lk.ey.com
- Sulaiman Nishtar  +94 11 246 3500  sulaiman.nishtar@lk.ey.com

**Ernst & Young LLP, Asia Pacific Business Group, New York**
- Chris Finnerty  +1 212 773 7479  chris.finnerty@ey.com
- Kaz Parsch  +1 212 773 7201  kazuyo.parsch@ey.com
- Bee-Khun Yap  +1 212 773 1816  bee-khun.yap@ey.com

**Ernst & Young LLP, Asia Pacific Business Group, Houston**
- Trang Martin  +1 713 751 5775  trang.martin@ey.com
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EYG no. CM6044
1508-1600216 NY
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