

# Setting up your Business in Sri Lanka

## Issues to consider



Sri Lanka has become an ideal location for Global Investment being -

- a) Situated at the cross roads of major shipping routes to South Asia and the Far East
- b) Gateway to the Indian subcontinent
- c) Logical location for establishing manufacturing and service organizations

Further:-

- Climate – good almost throughout the year
- People – Friendly with literary rate around 92% and ability to communicate satisfactorily in English.
- Government – Business friendly, encourages foreign investments, granting various incentives for selected sectors.
- Environment – Reasonably good road network, less industrial / noise pollution
- Skilled Manpower and professional managers – Available at reasonable cost
- Unskilled Labour – Easily trainable and available at comparatively cheaper cost
- Banking Systems – Fully developed with more than 25 commercial banks
- Electricity & Water – Available almost everywhere
- Telecommunication – Excellent
- Earnings and Capital – Can be repatriated, provided investment is made through a “Share Investment External Rupee Account” (SIERA) bank account.
- Legal System – reasonably sound and transparent.

However there are a number of issues which you must consider when you are looking to set up your business in Sri Lanka. This document takes you through some of the common questions we come across and gives you practical information about the issues you need to consider.

### What type of Business Structure should we use?

There are advantages and disadvantages to all of them, and there is no one correct answer. It is all dependent on your specific business circumstances and needs. A brief overview of the main structures is given below:

#### Establishment (a Branch of your Overseas Business)

- Not a separate legal entity but an extension of the overseas Parent Company
- No limited liability on Sri Lanka operations
- If have a permanent establishment (PE) in Sri Lanka, then profits from this PE are liable to Sri Lanka Corporation tax
- Must file **parent company accounts**, at Registrar of Companies (ROC) for inspection, even if these are not made publically available overseas. These accounts may also be required to be submitted to the Inland Revenue Department (I.R.D) to agree on ‘Head Office Expenses’ chargeable to the Branch.
- Income Tax Returns need to be filed with audited accounts of the Branch.

# Setting up your Business in Sri Lanka

## Issues to consider



### Limited Company:

- Provides limited liability and ring-fencing to Sri Lanka operations
- Gives a perception of a local business, with longevity
- Corporation Tax to be paid on Company profits
- Have to retain Sri Lanka company accounts up to 6 years to be filed with the Registrar of Companies only if called for.
- Accounts require auditing annually by Chartered Accountants.
- Income Tax Returns need to be filed with audited accounts of the Company.

### How much Corporation Tax will the business pay?

Current Corporation Tax rates in Sri Lanka are:

Type of Company	Tax rate (%)	Taxable profit (SLR)
Small Company	12	0 - 5,000,000
Other Companies	28	Over 5,000,000

(NB: rates are for the tax year to 31 March 2014 & 2015)

Tax Holidays and Concessionary Tax Rates are applied to certain approved activities.

A minimum dividend of 10% of the 'Distributable Profit' needs to be declared and Dividend Tax of 10% paid within 6 months from the end of the year of assessment, to avoid liability to penal rate of Deemed Dividend Tax (DDT).

### What if we use Sri Lanka to set up our holding company?

Sri Lanka's competitive tax legislation means that it is a very attractive place to set up a holding company.

If a Sri Lankan company holds shares in another company and these shares are subsequently sold then the resulting gain is exempt from tax.

Tax withheld Dividend Income is not taxed in the hands of the Holding Company.

The withholding tax of 10% is not payable on the Dividends declared out of such Dividend received by the Sri Lankan Company.

### What if we make cross-border transactions between group companies?

Sri Lanka Tax Laws recognises **Transfer Pricing (TP)** rules where cross-border trading and financial transactions between affiliated entities have to be conducted on an arm's length basis. The price and terms should be the same as if the transactions had been between completely independent parties. Though the provisions were incorporated in the Tax Legislations long ago, the Revenue Department has commenced imposing these provisions more strictly from recent past.

Typical transactions between affiliated entities that are covered by TP regulations are:



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## Issues to consider



- Sale and purchase of goods
- Provision of management services
- Property rental charges
- Transfer of intangible assets e.g. trademarks, patents
- Sharing of knowledge, expertise, business contacts etc.
- Provision of financial support e.g. inter-group loans and charging a “market” interest on loans

A business will need to prepare a Transfer Pricing Report proving the arm’s length basis of transactions. The report will include a functional and risk analysis, analysis of the adopted pricing model and benchmarking of the arm’s length basis.

Small and Medium Enterprises (SMEs) are generally exempt from transfer pricing regime, However “large” entities need to undertake detailed TP analysis. A “large entity” for TP purposes is one where Turnover is more than SLRs.250 Mn or Statutory Income is more than SLRs.100 Mn or is a Quoted Public Co. However even if an entity is exempt from transfer pricing regime, it may fall under the scrutiny of the other international tax jurisdictions where it transacts. There may also be other tax regulations which ensure transactions are undertaken at a commercial value.

### What Employment Taxes and Social Security will need to be paid?

If an individual is resident in Sri Lanka then they are subject to Sri Lankan Tax Laws. Briefly, an individual who is physically present in Sri Lanka for 183 days or more in any year of assessment, shall be deemed to be Resident in Sri Lanka throughout that year of assessment.

### Current Personal Income Tax rates in the Sri Lanka are:

Band of income (SLR)	Tax rate (%)
*Statutory Allowance Rs.500,000	Exempt
Next 500,000	4%
Next 500,000	8%
Next 500,000	12%
Next 500,000	16%
Next 1,000,000	20%
Balance	24%

\* Statutory allowance is only for Resident and Non Resident Citizens of Sri Lanka.

With effect from 01.04.2014 profits and income of an individual (Citizen of Sri Lanka) from provision



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## Issues to consider



of Professional Services, forming part of taxable income are taxed as follows.

Tax Slabs SL Rs.	Tax Rate	Tax Liability SL Rs.
500,000	-	-
500,000	4%	20,000
500,000	8%	40,000
24,000,000	12%	2,880,000
10,000,000	14%	1,400,000
Balance	16%	

It is the employer's legal responsibility to pay the employee's Pay As You Earn (PAYE) Tax to the Inland Revenue Department.

Employee's Provident Fund deducted from the employee (@ 8% of Gross Remuneration) together with the Employer's contribution of 12% has to be remitted to the Employees' Provident Fund (E.P.F) Department, and a further 3% contribution by the Employer has to be remitted to the Employees Trust Fund (ETF) Department.

### What is Value Added Tax (VAT) and should the business be registered?

VAT is a "goods and services tax" on supplies made, the standard rate of which is 12%. If a business makes taxable supplies in excess of SLRs.3 Mn in any quarter or SLRs.12 Mn in any year, then it must be registered for VAT.

There are three types of supplies -

- Liable supplies – Exports Zero rated Supplies – Can claim input VAT
- Liable supplies – Others:- must charge VAT on supplies made and Can reclaim input VAT
- Exempt supplies – Cannot charge VAT nor reclaim input VAT

The supply of most types of goods and services in Sri Lanka would be classed as Taxable Supplies.

### Nation Building Tax (NBT)

Nation Building Tax (NBT) @ 2% of the liable Turnover of Manufactured and Service Supplies and on 50% of the Liable Trading (Buying and Selling) Turnover is payable where such Turnover exceeds SLRs.3,000,000/- in any quarter.

This is an expense to the organization.

### Economic Service Charge (ESC)

Economic Service Charge (ESC) @ 0.25% is payable on the Exempt Turnover of any Business or on the total turnover of any Business where such Business incurred a Tax Loss in the previous year and where such Turnover exceeds Rs.50 Mn in a quarter.

However such ESC paid can be set off against any income tax payable by the entity.

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### **Can we provide Share option plans to our staff?**

Many companies see Share Option plans as being an important way of attracting, motivating and retaining key staff.

Sri Lanka has share option plans which give tax benefits to employees and employers.

However this is a technically complex area and careful planning needs to be undertaken as soon as share option plans are being considered for implementation.

### **How else can we compensate our employees?**

Employee Benefits given will be liable to tax in the hands of the employee except some partial Cash and Non Cash reliefs relating to Travelling / Vehicle, Housing, Furniture and Telephone, details of which may be furnished if required.

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