Budget Analysis 2022

Towards a Resurgence

Tax Proposals | November 2021

Table of Contents

Economic Impact 06

Key Tax Proposals Direct Taxes 11

Key Tax Proposals Indirect Taxes 13

Key Tax Proposals Administrative Provisions 17

Other Proposals 19

About KPMG Sri Lanka 22

Foreword

KPMG
32A Sir Mohamed Macan Markar Mw
P O Box 186
Colombo 00300
Sri Lanka

Tel 94 (11) 5426 426
Fax 94 (11) 2445 872
E-mail kpmgsl@kpmg.com
Internet www.kpmg.com

12th November 2021

For the clients of KPMG Sri Lanka

The budget proposals for 2022 were presented in Parliament today by the Hon. Minister of Finance, Basil Rajapakse. Whilst the Minister noted the challenges before the nation, the proposals focused on improving the overall infrastructure of the country, while providing relief to vulnerable communities in keeping with the "Vistas of Prosperity and Splendour", the policy framework of the government.

This publication has been compiled on a high-level review of the proposals in the limited time available to us. We may also emphasize that these proposals need to be enacted by Parliament for legal enforcement.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

KPMG

Chartered Accountants

Budget 2022 at a Glance

New Taxes and Levies

Surcharge Tax at 25% on persons with taxable income exceeding Rs. 2 Billion.

Social Security Contribution on liable turnover exceeding Rs. 120 Million at the rate of 2.5% to be introduced.

Fees to be levied in relation to motor vehicles.

Development of the Agriculture Sector

An allocation of Rs. 39 Billion for the promotion of usage of non - toxic weedicides and organic fertilizers with an allocation of Rs 22 Billion for the introduction of new agro-technologies.

Consolidation of taxes as a Special Goods and Services Tax

A Special Goods and Services Tax to be introduced on telecommunication, motor vehicles, cigarettes, liquor, betting and gaming in lieu of various taxes and levies imposed under different Acts and administered by different Government Departments.

Revision to Teachers' salaries

An allocation of Rs. 139 Billion to be allocated to revise salaries of teachers and principals.

Budget 2022 at a Glance (Cont.)

Infrastructure Development

An allocation of Rs 49 Billion for the "Water for All" programme with the aim of providing uninterrupted clean drinkable water supply.

An allocation of Rs 68 Billion for the " Vari Saubhagya" programme with the aim of developing the irrigation system.

An allocation of Rs 280 Billion for the National Road Development programme.

Increase of VAT and Excise Duty

VAT rate on supply of Financial Services to be increased to 18%

Increase of Excise duty on cigarettes and liquor

Rural Development

Allocations to be made for the "Gama Samaga Pilisandara" programme for uplifting the standard of living and development of rural infrastructure.

Social Welfare and Relief Programmes

An allocation of Rs. 31 Billion for the "Home Economy Security" Programme with the aim of providing relief to pregnant mothers and economically challenged families, and to establish a mini supermarket network.

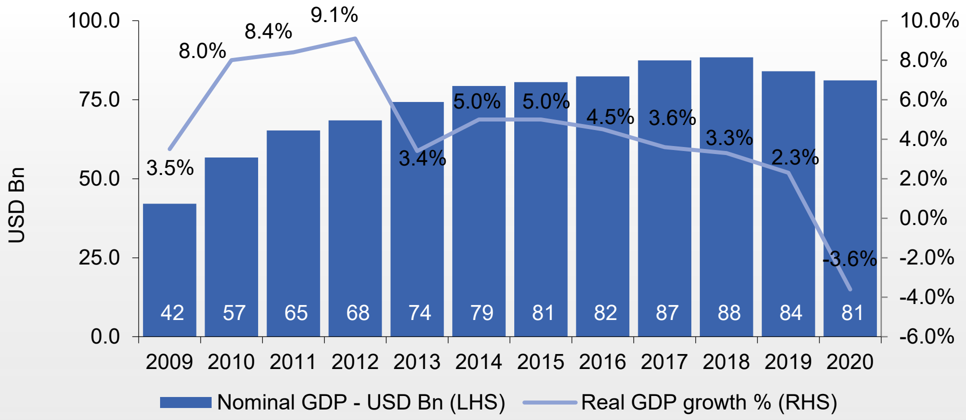
Economic Impact

Real sector (1/2)

GDP

- Sri Lanka's real GDP contracted by 3.6% YoY in 2020, primarily on account of the COVID – 19 pandemic impact on the global and local economy, which was further exacerbated by adverse weather conditions at the beginning of the year.
- Accordingly, the country recorded a nominal GDP of USD 81.1 Bn in 2020 and remained a lower middle-income country with a GDP per capita of USD 3,682 during the same period.
- However, with the gradual recovery of the economy, strengthened by vaccine rollouts, Sri Lanka recorded an economic growth of 8.0% YoY during the 1H2021.
- Looking forward, the Central Bank of Sri Lanka (CBSL) expects the economy to grow by 5.0% in 2021 while the World Bank and the International Monetary Fund (IMF) expects a more conservative growth of 3.4% and 4.0% respectively, on account of a resumption in domestic trade, consumption and manufacturing buoyed by the local vaccine roll-out.

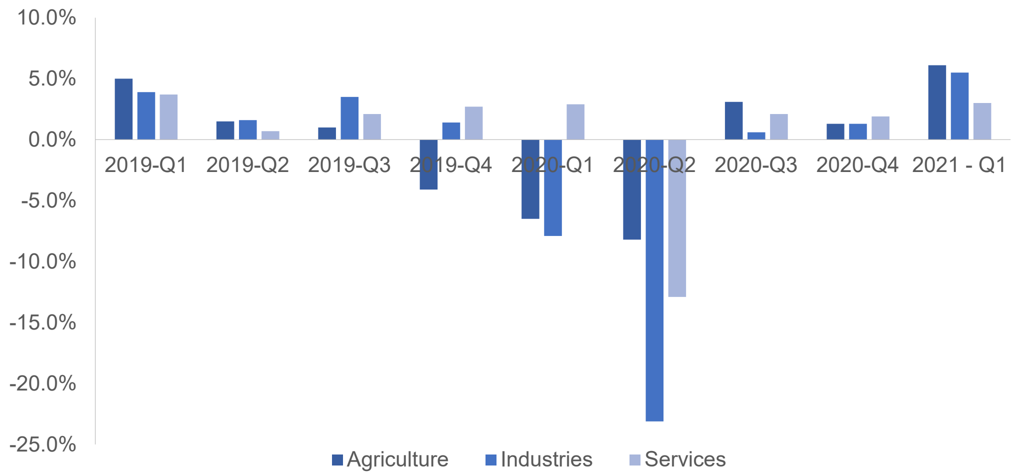
Gross domestic product



Source: Central Bank of Sri Lanka

Sectoral Distribution of GDP

Quarterly Real GDP Growth by Sector (%)



Source: Central Bank of Sri Lanka

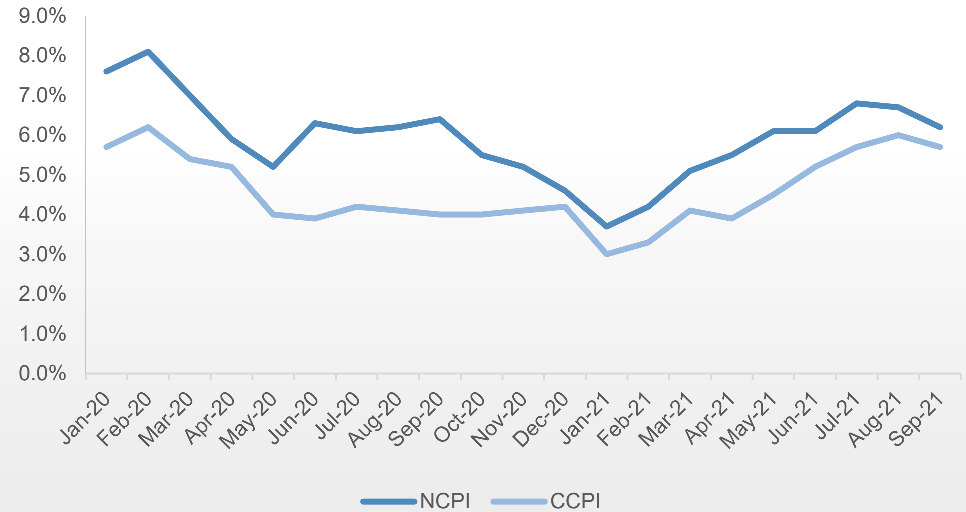
- The Agriculture sector contracted 2.4% YoY while the Services and Industry sectors, contracted by 1.5% YoY and 6.9% YoY respectively in 2020. However, the economy witnessed a v-shaped recovery in all sectors in 3Q2020 with the gradual resumption of economic activities post lifting of lockdowns.
- Tourism, Sri Lanka's third largest generator of foreign exchange, suffered a significant setback in 2020 with only 507,704 tourist arrivals in the few months the country's borders were open. The dismal performance in 2020 followed the Easter attacks in 2019, which caused tourist arrivals to drop to 1.9 Mn during the year from the 2.3 Mn arrivals recorded in 2018.
- Unemployment rose steadily in 2020 and reached a high of 5.8% in 3Q2020. The negative impact of the pandemic continued onto 2021 with unemployment reaching 5.7% in the 1Q2021.

Real sector (2/2)

Inflation

- Inflation as measured by the National Consumer Price Index (NCPI) reached 6.2% YoY (measured as a 12-month moving average) in 2020, notwithstanding lower. consumption and import restrictions on selected consumer and non-consumer goods.
- Notably, food inflation rose to 12.2% YoY in 2020 due to the restrictions on select food imports and disruptions to domestic supply chains.
- Supply shortages exacerbated by import restrictions continued onto 2021 as witnessed by the NCPI and CCPI rising sharply from January 2021 to September 2021 at 5.6% and 4.6% on a monthly average inflation level, respectively.

YoY Inflation

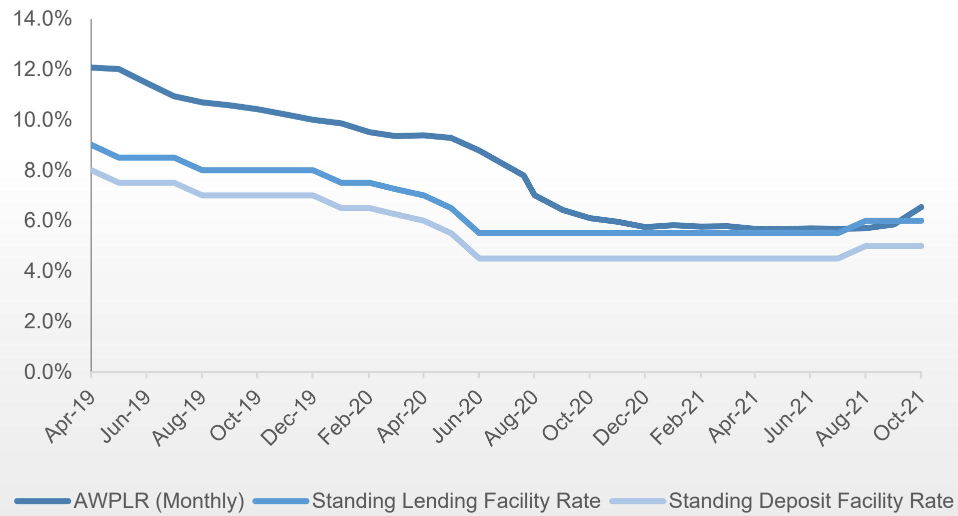


Source: Central Bank of Sri Lanka

Interest Rates

- In order to stimulate the economy from the fall out of the COVID – 19 pandemic, the CBSL lowered key policy rates five times in 2020, resulting in the standing deposit facility rate and the standing lending facility rate to fall by 250bps during the year. The Statutory Reserve Ratio (SRR) was also reduced on this background.
- Accordingly, the Average Weighted Prime Lending Rate (AWPLR) declined from 9.9% in January 2020 to 5.7% in December 2020. However, commercial lending rates have picked up in 2021 as indicated by 6.5% AWPLR as of October 2021.
- The CBSL granted debt moratoriums and introduced credit guarantee schemes for affected industries during the pandemic which continue to be in place in 2021.

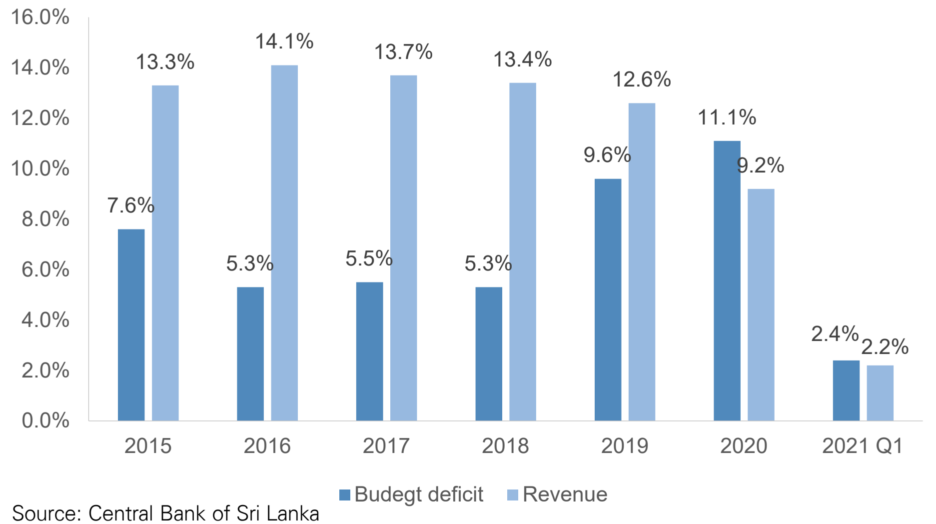
Policy Rates



Source: Central Bank of Sri Lanka

Fiscal sector

Fiscal Balances

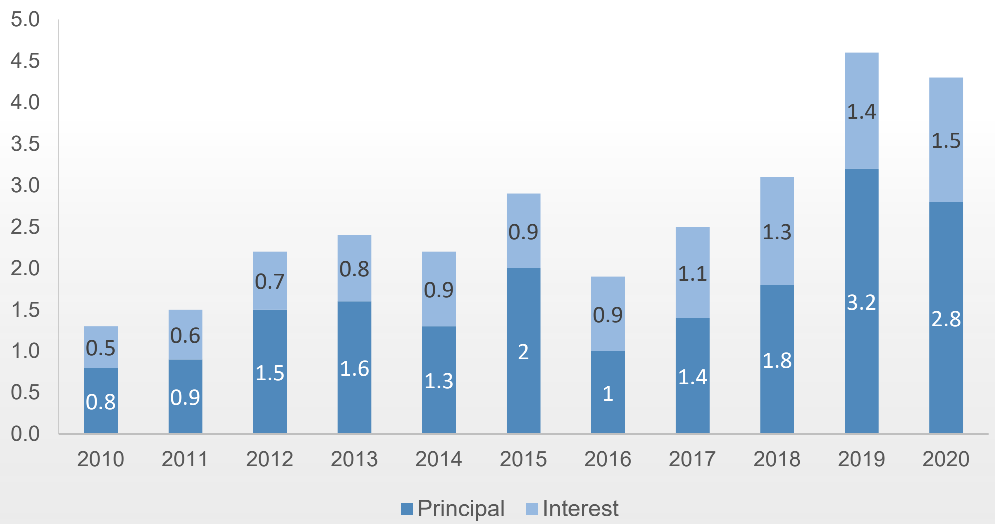


Source: Central Bank of Sri Lanka

- Sri Lanka's budget deficit widened from 9.6% of GDP in 2019 to 11.1% of GDP (amounting to LKR 1,667.7 Bn) in 2020, on account of the economic slowdown, high relief expenditure and post-Presidential Election 2019 tax cuts.
- The post election tax cuts notably caused tax revenues to decline from 12.6% of GDP in 2019 to 9.2% of GDP (amounting to LKR 1,373.3 Bn) in 2020, which was further impacted by a decline in the import related tax collection that was challenged by import restrictions during the year.
- The impact of the tax cuts and the pandemic continued onto 1Q2021, resulting in a budget deficit of LKR 520.5 Bn that notably exceeded 1Q2021 revenue of LKR 481.7 Bn during the year.

Government Debt

- Total debt service payments for 2020 amounted to USD 4.3 Bn, of which USD 2.8 Bn was principal repayments and the balance USD 1.5 Bn was interest payments. On this note, the country's debt-to-GDP ratio stood at 101.0% at the end of 2020.
- As at end-April 2021, the GoSL's outstanding foreign debt was USD 35.1 Bn with International Sovereign Bonds (ISBs) accounting for 46.7% of the foreign currency debt stock (USD 16.4 Bn). Notably, over USD 5.0 Bn in foreign debt repayments is expected to be made in 2022 and beyond.
- In its six- month road map presented in October 2021, the CBSL announced its target to reduce the Government's ISB exposure to 10.0% of GDP by 2024.



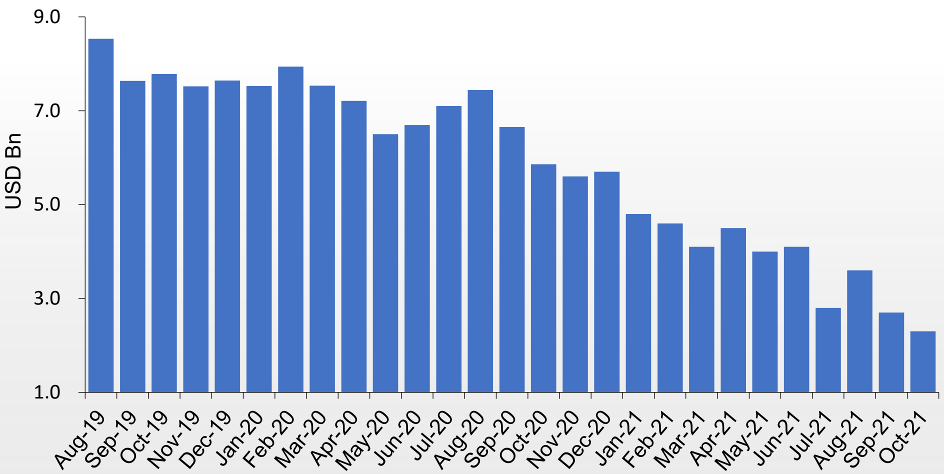
Source: Central Bank of Sri Lanka

External sector

Foreign Reserves

- As of end 2020, Sri Lanka's gross official foreign reserves fell to USD 5.7 Bn as a result of repaying a USD 1.0 Bn sovereign bond maturing in October 2020, instead of rolling over.
- The above was despite the worker remittances growing 5.8% YoY during 2020, while the trade deficit contracted 25.0% YoY to USD 6.0 Bn on account of lower imports.
- Reserves continued to decline in 2021 post another sovereign bond repayment of USD 1.0 Bn in July 2021, to a significant low of USD 2.3 Bn as of October 2021.
- In lieu of over USD 5 Bn in foreign debt repayments expected amidst the challenging macro economic environment in 2022, S&P downgraded Sri Lanka's credit rating to CCC+ in August 2021 followed by Moody's downgrading the sovereign to Caa1 in October 2021.

Gross official reserve assets

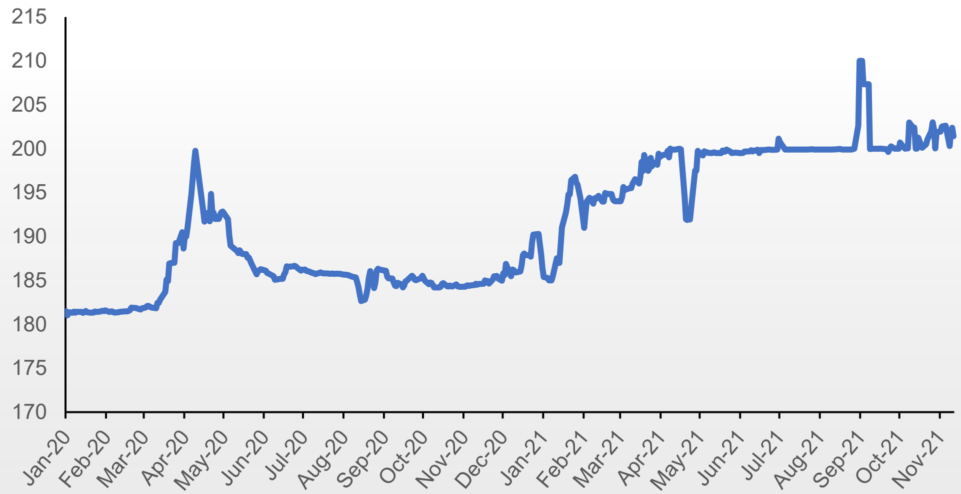


Source: Central Bank of Sri Lanka

Exchange Rate

- Debt sustainability issues exacerbated by unfavorable economic conditions stemming from the COVID – 19 pandemic, contributed towards the depreciation of LKR which declined 2.6% against the USD in 2020.
- The volatility of LKR continued onto 2021 whereby the LKR depreciated by 8.9% against the USD from January to end October 2021. Depreciation against Euro, Australian Dollar, Sterling Pound and Indian Rupee was also witnessed.
- To curtail the significant exchange rate loss, the CBSL imposed import restrictions via bank suspensions for motor vehicle imports and all non-essential goods, introduced Special Deposit Accounts (SDAs) with higher-than-market interest rates for dual citizens and enacted mandatory conversion rules for export proceed receipts.

Exchange rate - LKR/USD



Source: Central Bank of Sri Lanka

Key Tax Proposals

Direct Taxes

Direct Taxes

Surcharge Tax

- It has been proposed to impose a one - time surcharge tax of 25% on individuals or companies with a taxable income exceeding Rs. 2 Billion for the Year of Assessment 2020/2021.

- The budget proposal does not indicate the base on which surcharge tax is to be imposed. We note that similar surcharge tax has been imposed in the past as a percentage of the total income tax payable by a person for the relevant year, or as a percentage of taxable income.

- We note that a surcharge on Income Tax has been imposed from time to time in Sri Lanka since 1961. Surcharge on Income Tax imposed for the following Years of Assessment, ranged between 10% to 20%;

  – 1960/1961
  – 1978/1979 to 1981/1982
  – 1984/1985
  – 1989/1990 to 1995/1996
  – 2001/2002

- From 2005 – 2011, a similar levy was imposed in the form of Social Responsibility Levy ("SRL") at the rate of 0.25% (which was gradually increased to 1.5%) on all taxes chargeable under the enactments specified under the Act. (i.e., Inland Revenue Act, Customs Ordinance, Excise Ordinance and Excise (Special Provisions) Act).

- In 2015, a Super Gain Tax was imposed at the rate of 25% on taxable income of an individual or a company for the Year of Assessment 2013/2014, where the profits as an individual entity or as a Group exceeded Rs. 2 Billion.

- This proposal will have to be further studied to understand the base on which the tax would be imposed, to ascertain the scope of chargeability.

Tax Concessions

- It has been proposed to grant tax concessions for investments into establishment of international schools and hospitals with the view to reduce district level disparities identified in education and health facilities.

- The proposal does not provide details of the exact concessions to be provided.

Key Tax Proposals

Indirect Taxes

Indirect Taxes

VAT on Financial Services

- It is proposed to increase the VAT on FS rate payable by the Specified institutions to 18% from 15%.This rate increment will be applicable only for a period of one year commencing on 01 January 2022 and ending on 31 December 2022. The expected revenue by the Government from the increased rate is Rs.14 Billion.

- Specified Institutions cover a licensed commercial banks, a finance companies and a licensed specialized banks.

- The VAT on FS was introduced in 2003 at the rate of 10% and it was chargeable on the supply of financial services by Specified Institutions. Subsequently, through amendments the chargeable person was extended to cover both Specified Institutions or persons carrying on the business of supplying defined financial services.

- As per the Department of Inland Revenue Annual Performance Report for 2020, the revenue collection from VAT on FS is as follows;

Total registered taxpayers as at 31.12.2020- 239		
Estimated Revenue-Rs."000"	Revenue Collected- Rs."000"	Collection as % of estimate
48,000,000	42,451,851	88%

VAT Exemption

- The tax exemption granted on import or supply of goods listed under item (xxxi)of paragraph (a) of Part II to the First Schedule to the Act would be amended as follows.

  "medical equipment, machinery, apparatus, accessories and parts thereof and hospital furniture, drugs and chemical donated to a Government hospital or the Ministry of Health for the provision of health services to address any pandemic or public health emergency approved by the Ministry of Finance on the recommendation of the secretary to the Ministry of the Minister assigned with the subject of health with effect from January 1 2022."

- As per the above amendment tax emption on "surgical and dental instrument" has been removed.

Special Goods and Service Tax

- The Special Goods and Service Tax (GST) which was proposed in the Budget 2021 is proposed to be implemented from 01 January 2022.

- In the Budget 2021, it was stated that an online managed single special goods and services tax would be proposed on telecommunication, motor vehicles, cigarettes, liquor, betting and gaming in lieu of various taxes and levies imposed under different Acts and administered by different Government Departments.

Indirect Taxes

Special Goods and Service Tax (Cont.)

- It is mentioned in the Budget 2022 speech that the legal provision in relation to GST is already drafted. We await the draft Act for guidance on rate and collection mechanism.

- The following is a synopsis of the current indirect taxes applicable on the aforementioned industries.

Telecommunication Services

- Currently, the telecommunication services are subject to Telecommunication Levy, Cess (administered by the Telecommunications Regulatory Commission) and VAT (administered by the Department of Inland Revenue). The telecommunication industry first witnessed the composite tax called Telecommunication Levy in lieu of VAT and NBT in 2011. Later, in 2016, VAT and NBT were re-imposed on telecommunication industry in addition to the Telecommunication Levy. NBT was discontinued from December 2019.

Motor Vehicles

- A composite tax was introduced in 2014, on motor vehicles specified under Chapter 87 of the tariff guide for both import and supply of such vehicles in lieu of VAT and NBT.

- In addition to the composite tax, Custom Duty and Port and Airport Development Levy are imposed at the point of importation. Further, Luxury Tax on Motor Vehicles was introduced in 2019 in lieu of Annual Luxury Motor Vehicle Tax on prescribed motor vehicles. ESC imposed on importation of motor vehicles w.e.f. April 2017 was discontinued from January 2020.

Cigarettes and Liquor

Currently, cigarettes and liquor are subject to Excise Duty and VAT. A composite tax was introduced in 2014, for cigarettes and liquor in lieu of VAT and NBT. However, VAT and NBT was reintroduced from November 2016 on cigarettes and liquor in addition to the Excise Duty. NBT was discontinued from December 2019.

Betting and Gaming

Currently, the business of betting and gaming is subject to VAT or to an annual levy for carrying on the business of gaming and a levy on gross collection of the business as the case may be. Further, a Casino Entrance Levy is imposed and collected from the persons entering such places of gaming.

Social Security Contribution

- It is proposed to introduce a 2.5% levy termed "Social Security Contribution " on excess over annual turnover Rs.120 million, to rebuild the economy affected by the COVID pandemic with effect from 01 April 2022.The expected revenue by the Government from the levy is Rs.140 Billion.

- Further guidelines to be issued on the collection mechanism.

Indirect Taxes

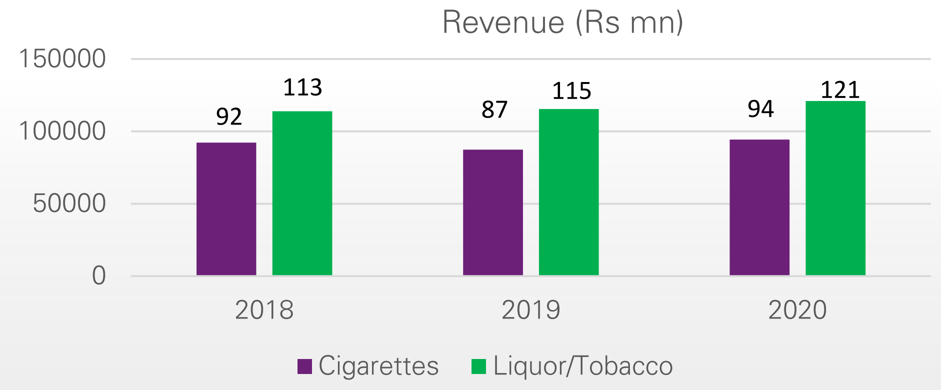
Excise Duty [Under Ordinance and (Special Provisions) Act]

- In order to enhance the efficiency, it is proposed to expedite the digital revenue collection system and measures be taken to simplify the excise licensing process.

- It is proposed to increase the excise duty with immediate effect. The Government expects an additional revenue of Rs 25 Billion.

- Tax on cigarettes would be increased by Rs 5 with immediate effect. This proposal is expected to contribute Rs 8 Billion in revenue.

- The excise duty collection from Cigarettes/Liquor and Tobacco for the past 3 years is as follows;



Source : Ministry of Finance Annual Report

- The special goods and services tax (GST) which was proposed in the budget speech of 2021 would be implemented from 01st January 2022 as per the budget speech of 2022. The special GST was proposed to be introduced as a single tax in lieu of the multiple taxes and levies. With the proposed implementation of this proposal from 01st January 2022, the current excise duty should be absorbed under the special GST rate. We would have to await the specific laws in relation to these proposals to identify whether the multiple taxes and levies has been replaced by a single tax.

Sri Lanka Customs

- Several measures has been proposed in order to improve the efficiency and to facilitate an efficient flow of imports and exports.
  - ➢ A Single Window System to be established to facilitate the import-export process by integrating all the institutions that work with Sri Lanka Customs into one system.
  - ➢ To provide exporters with the highest gradings with free customs facilities.
  - ➢ Update the HS Codes system to avoid deficiencies.
  - ➢ Customs duties and CESS rates to be simplified with regard to certain HS codes other than liquor, cigarettes, motor vehicles and domestically produced agricultural products.

- A specific import restriction has been imposed on importation of rubber related products with the intention of promoting local manufacture of rubber related products instead of exporting rubber as a raw material.

Key Tax Proposals

Administrative Provisions

Administrative Provisions

Efficient Tax Administration

- It has been proposed to strengthen the tax administration by consolidating different units of the Department of Inland Revenue managing files of large taxpayers with the view of increasing the revenue generated from large taxpayers.
- Completion of full implementation of RAMIS to be expedited.
- Integration of all bank and financial institutions to the online tax payment platform.
- Amendments to the tax law to be introduced to legitimize the use of digital identification numbers.
- A Single Window System, which would integrate all institutions connected to Sri Lanka Customs, to be introduced to facilitate import and export process.
- A mechanism to examine the accuracy of tax documents filed through digital platforms to be introduced and permission to be granted to accept digital invoices and documents as valid documents, wherever possible.

Simplification of new business registration process

- The Finance Act to be amended to facilitate the simplification of the complex processes for registration of new businesses being implemented by the Board of Investment, Department of Foreign Exchange and Export Development Board including consolidation of fees levied by various institutions for same.

Digitalization of Tax Assessment Process

- It has been proposed to introduce legal provisions for application of technological processes relating to tax assessment and collection procedures with view to strengthen collection of taxes in default.

Technical Rectifications to the Tax Laws

- It has been proposed to make relevant amendments to the Value Added Tax No 14 of 2002 and other relevant acts to rectify discrepancies and ambiguities .

Other Proposals

Other Proposals

Proposed fees in relation to motor vehicle

- Certain revenue proposals for motor vehicles have been proposed for which the Government expects a revenue of Rs 4 Billion.
- To charge a fee on vehicles meeting with accidents with the intention of reducing roadway accidents. However, this can be reimbursed from the insurance.
- It also has been proposed to impose a fee on vehicle modification, alteration, and refurbishment. This proposal has to be reviewed further since it is unclear as to the point of collection of this fee.
- In relation to illegal motor vehicles and motorcycles an amnesty period has been introduced where upon a payment of a fine registration could be obtained.
- Further it is proposed to release all the vehicles seized at the Customs which are pending clearance due to non-payment of applicable taxes subsequent to a payment of the applicable taxes and fines.
- The Budget speech made no reference to the ongoing import suspension on motor vehicles.

Non-Tax Income

- It is proposed to collect Rs 25 Billion from license fees, auctions and other non-tax revenue.
- It is proposed to charge a leisure license fee on licenses issued under Goods and Services Tax for the special zones designated for leisure activities.
- A fee is to be charged on licenses issued by the Telecommunication Regulatory Commission of Sri Lanka via an auction.
- The fee charged in relation to motor vehicles which generates revenue of Rs 4 Billion has also been listed under nontax income of Rs 25 Billion. This would need to be rectified.

Other Proposals

Introduction of new Acts and Amendments to existing Acts

- New Laws and Regulations would be introduced by Central Bank of Sri Lanka, to encourage the banks to convert their branches into smart banking units using digitalization.
- A new Special Finance Act would be introduced to safeguard the local and foreign exporters to ensure the safety of transactions of foreign current accounts and to simplify foreign currency conversions and transfers.
- Introduce new Finance Act to establish free ports.
- Introduce new Laws on usage of lands owned by plantation companies, both public and private owners, to ensure the maximum utilization of buildings and other assets.
- A new amendment will be introduced to the relevant statutes to amalgamate life and property insurance of Sri Lanka Insurance Corporation.
- A new Act will be introduced to safeguard the Rights of the Differently-abled.
- A new Act will be legislated titled "Green Agricultural Development Act" in order to protect and safeguard, the traditional knowledge, right to lands ,right to the distribution of water etc.

Simplification of existing systems and procedures

- Introduce new amendments to the Laws and Regulations that impede the inflows of foreign exchange earned by freelancers through development and upgrading of new software.
- Amendment will be introduced to the Finance Act to simplify the current new business registration process adopted by the Board of Investment, Department of Foreign Exchange and Export Development Board and to consolidate fees levied by various institutes.
- It is proposed to simplify the stringent rule currently applicable for registration of ships in order to transform Sri Lanka to a naval hub in the global context.
- It is proposed to convert the Samurdhi Banks as one-stop shops, for the development of micro and small enterprises.

Others

- The business registration fees will not be levied in the year 2022 in order to incentivize new start-ups.
- Retirement age of public sector employees to be extended to 65 years from 60 years in order to strengthen the labour force. The Budget 2021 proposed to amend the Employees' Provident Fund Act to expand the retirement age for both men and women in the private sector up to 60 years.
- A contributory pension scheme would be established for senior citizens who do not currently receive pensions.

About KPMG Sri Lanka

KPMG Leadership Team

Reyaz Mihular
Managing Partner

Audit

Suren Rajakarier
Partner, Head of Audit

Yohan Perera
Partner, Audit

Ranjani Joseph
Partner, Deputy Head of Audit, Head of Markets

Chamara Abeyrathne
Partner, Audit

Upul Karunaratne
Partner, Audit

Thamali Rodrigo
Partner Audit & Family Business Consulting

Rajesh Rajan
Partner, Audit

Shameel Nayeem
Partner Audit & IT in Audit

Dhammika Rajapakse
Partner, Audit

Raditha Alahakoon
Partner, Department of Professional Practice (DPP)

Pyumi Sumanasekara
Partner – Sustainability, ESG, Global Assurance

Tax

Shamila Jayasekara
Partner, Head of Tax & Regulatory

Suresh R.I Perera
Principal, Tax & Regulatory, Deputy Head of Markets

Advisory

Priyanka Jayatilake
Partner, Head of Advisory

Kamaya Perera
Partner, Head of Management Consulting

Jagath Perera
Partner, Internal Audit Risk, Compliance Services & Forensic Services

Shiluka Goonewardene
Principal, Head of Deal Advisory, Deputy Head of Markets

Dulitha Perera
Partner, Risk & Healthcare Consulting

Ajantha Weerasekara
Principal - Advisory

About KPMG Sri Lanka

1,000+
People locally

20
Partners

Audit 674

Tax 68

Advisory 281

Part of
147
Countries in the
Global Network

Established in
1897
The oldest
Chartered Accountancy
firm in the country

Combined Global Revenues
$28.96
USD in Billions
USD in Billions

Celebrating,
124 years
of excellence
of excellence

KPMG Recognitions

KPMG Sri Lanka renewed its ACCA Platinum Employer Status for Training and Professional Development up to 2021

Sector winner in financial services by LMD's most respected entity in Sri Lanka for 2021

First in Financial Services Category LMD Most Respected 2019

First in the Auditors League in Sri Lanka LMD 100 - 2017

Best Corporate Advisory Firm - Sri Lanka 2021 Global Economics Awards

Best Advisory Firm in Sri Lanka The International Finance Magazine 2016

Best Deal Advisory Firm in Sri Lanka Global Banking and Finance Review 2015

Recognized for Professionalism and Integrity LMD Most Respected 2017

Sri Lanka Tax Firm of the Year Asia Tax Awards 2018

Forrester Wave Leader – 2019 – Global Cyber Security Consulting Services

Oracle SaaS Partner of the Year 2018
Oracle ERP Partner of the Year 2018
Oracle SCM Partner of the Year 2018

Contact Us

Shamila Jayasekara
Partner - Head of Tax and Regulatory
KPMG Sri Lanka
T: +94 115426503
M: +94 777751770
E: sjayasekara@kpmg.com

Suresh R.I Perera
Principal - Tax and Regulatory
KPMG Sri Lanka
T: +94 115426502
M: +94 777394367
E: sperera@kpmg.com

Follow us on,

KPMG Sri Lanka

@kpmgsl

KPMG Sri Lanka

www.home.kpmg/lk