TAX ALERT

The new tax measures agreed during the 02nd review by the IMF

IMF Country Report – Extended Fund Facility (EFF)

June 2024

IMF Country Report
What is the tax impact?

In March 2023, the IMF Executive Board approved a 48-month extended arrangement under the extended fund facility, to support Sri Lanka's economic policies and reforms.

The IMF Executive Board expressed its views on 12 June 2024, on the staff level report completed on 29 May 2024, following the discussions with Sri Lankan officials in March.

This tax alert seeks to highlight the salient features of the new tax measures discussed and included in the IMF staff report on the second review.

1. Imputed Rental Income Tax (IRIT)

- It has been proposed to introduce an imputed rental income tax on the income of individuals (rather than real property itself), on owner-occupied and vacant residential property, as a substitute to Property Tax mentioned in the IMF Report dated 30 March 2023.
- Imputed rental income is the deemed income that homeowners could earn if they rented out their homes.
- A press release was published by the Ministry of Finance on 16 June 2024 clarifying that the focus of this tax is on high wealth individuals and not the average income earners.
- As per the IMF Report, IRIT is expected to be implemented w.e.f. 01 April 2025 with an exemption threshold and a graduated tax rate schedule to ensure progressivity.

Refer Annexure 1 for the press release from the Ministry of Finance.

As per the IMF Report, the proposed IRIT is not a transaction tax and is imposed on individuals

Clarity needed whether IRIT will be on lessor or lessee in case of rented residential property.

Where a company is the owner/ lessor of a residential house, whether IRIT will be applicable?

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2. Removal of exemption for service exporters

Removal of the Corporate Income Tax (CIT) exemption on the export of services granted under the Third Schedule of the Inland Revenue Act No. 24 of 2017.

What would be the impact of the inflow of foreign currency whilst this would create parity between exporters of goods & services?

3. Increase of CIT rate for specified sectors

Increase the Corporate Income Tax (CIT) rate on betting and gaming, tobacco and liquor industries from 40% to 45%

Incremental tax expected is 0.08% of the GDP

4. Replacement of SCL with VAT

Introduce Value Added Tax (VAT) at a rate of 18% on items currently subjected to the Special Commodity Levy (SCL).

SCL is generally imposed on essential goods. Should there be an introduction of a lower rate of VAT on these essential goods?

5. VAT on supply of Digital Services

It is proposed to introduce VAT on the supply of digital services.

At present, only the local digital service providers are liable for VAT

6. Lifting the import ban on MV & other imports

- Proposal to lift of import restrictions on motor vehicles (MV) and other imports.
- This is expected to be achieved in a phased out manner.

Lifting the import ban on MV is expected to enhance revenue by 0.8% of GDP

7. Continuing efforts to repeal SVAT by April 2025

Approval has been obtained from the Cabinet to build a VAT refund system to achieve a full repeal of Simplified VAT (SVAT) by April 2025.

What are the mechanisms established to expedite the VAT refund process in order to repeal the SVAT by April 2025?

8. Increase of Stamp Duty on leases of land

The IMF Report states that an increase of the stamp duties on lease contracts from 0.1% to 0.2% would lower transfers to Provincial Councils and thus lower spending.

Stamp duty on lease of land is levied at 1% (not 0.1%) under the S 4(i) of the Stamp Duty (Special Provisions) Act No. 12 of 2006 read in conjunction with Gazette Extraordinary No. 1439/1. Such Stamp Duty is collected by the Commissioner General of Inland Revenue (CGIR). Hence, this statement is inaccurate.

Contact Us
KPMG Tax Team

Annexure 1

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MINISTRY OF FINANCE, ECONOMIC STABILIZATION & NATIONAL POLICIES

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PRESS RELEASE

Clarification on Imputed Rental Income Tax

The recent publication of the International Monetary Fund (IMF) supported Extended Fund Facility (EFF) programme related documents make reference to a proposed property tax to be implemented as an imputed rental income tax. The purpose of this press release is to clarify certain speculations and misconceptions regarding the same.

One of the key reasons for Sri Lanka's deep, complex and unprecedented economic crisis is the sharp decline in government tax revenue that led to high budget deficits and resultant escalation of public debt to unsustainable levels. Accordingly, the remedial measures to recover from the crisis have entailed a focused effort to improve the revenue of the government. Revenue based fiscal consolidation has been implemented during the last two years in an attempt to bring Sri Lanka's government revenue from a record low 8.3% of GDP in 2022 to 15% of GDP by end 2025. In the year 2023, tax reforms focused on progressive corporate and personal income tax measures. In 2024, revenue enhancement is supported by Value Added Tax (VAT) reforms, including elimination of most exemptions and rate adjustments.

Thus far, the revenue targets for 2023 have been largely met and target for 2024 is on track to reach the required level of 13.5% of GDP by end 2024. Therefore, there remains 1.5% of GDP revenue gains expected in 2025 in order to reach the 15% of GDP revenue target. The main revenue measure expected to help achieve the 2025 target is a wealth tax that is focused on property. From the outset of the IMF programme approval in March 2023, the revenue measures expected in 2023, 2024, and 2025 have been clearly presented in the public domain.

The envisaged property tax is in an advanced stage of design and therefore, it is premature to outline specific details of rates and thresholds. However, the focus of this tax is on high wealth individuals, and not on average income earners. This objective will be achieved by a suitable tax-free threshold to ensure that the tax is targeted on very high value property or multiple properties that are owned by wealthy members of society. This specific targeting is evidenced by the fact that the tax is expected to yield 0.2% of GDP by 2025 and 0.4% of GDP in a full year in 2026.

The design of the tax will also ensure appropriate set off mechanisms to avoid double taxation and any elements that distort economic incentives. Property taxes are implemented in many countries (including developing countries like India) since they are considered to be a highly efficient, progressive, and non-distortive means of generating revenue to fund public services.

The tax is expected to go through the regular legal process of amendments to the required legislation and is expected to come into force in April 2025. In addition to completing the legislative process, there is significant administrative work required to be done in terms of improving valuation mechanisms and databases in order to implement this proposed tax measure that was first announced in March 2023 with the publication of IMF programme documents. In fact, that is not a new tax measure. The Inland Revenue Act No. 10 of 2006 included a similar imputed income calculation termed "Net Annual Value". Property in Sri Lanka is also subject to existing taxes such as local authority Rates and Stamp Duty – therefore, there is significant precedence for such a property tax.

The continued improvement of government revenue and associated reduction in budget deficits has supported the government's efforts to restore economic stability, and has helped bring down interest rates and support appreciation of the currency, which brings with it material improvements to all citizens. A failure to reach the required level of government tax revenue that can fund public expenditure would lead to a recurrence of the economic crisis that had devastating impacts on the entire country.