



BUDGET SPEECH 2004
Part IV - Proposals

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**PART IV
2004 BUDGETARY PROPOSALS**

Tax Reforms

Mr. Speaker, any Government is dependent on the collection of tax revenues to pay for the infrastructure and other services provided to the public. A significant shortcoming in our tax revenue collection system is that the tax net is small. A large numbers of persons and businesses that should be paying taxes do not do so. The United National Front government has taken a systematic approach to address this problem. The comprehensive tax amnesty was a major success with over 50,000 declarations received, which is more than 10 times the number received under any previous amnesty. The Revenue Authority, being established to take over the Inland Revenue, Customs and Excise Departments will strengthen the process of tax administration in a systematic and fair manner, broaden the tax base and increase revenue collection.

Economic Service Charge

There are around 32,000 registered companies in the country. Less than 9,000 of them filed income tax returns for the year 2001/02 and just 2,850 of them paid income tax. In other words, less than 10% of the companies in the country pay income tax while the rest, who also use the same infrastructure and other services provided by the Government, make no contribution whatsoever towards meeting the cost of these services. This also applies to other forms of businesses such as partnerships and sole proprietorships.

We cannot permit this state of affairs

to continue. Every business must make some payment towards Government revenue collection, even if the amount is small. We cannot place greater burdens on businesses that already pay tax.

Therefore as a transitional measure to achieving a ratio of income tax to GDP that is comparable to that of other countries, I propose, with effect from April 1, 2004, to impose on all entities carrying on any trade, business, profession or vocation that have a turnover in excess of Rs 20 million or total assets in excess of Rs 10 million and which have been in commercial operation for more than two years, an Economic Service Charge (or ESC) of 1%, payable on turnover or total assets. Each business will be permitted a one time choice of whether the 1% ESC should be applied to turnover or total assets. The ESC can be set off against income tax payable for the year, limited to the full amount of tax payable without any carry forward provision. The minimum ESC payable by an entity which is liable to this charge will be Rs 100,000, and the maximum amount payable will be Rs 20 million.

A request will be made to BOI companies to submit to the ESC from 2005/06 as a measure of fairness in view of their enjoying the same infrastructure and other Government services in conducting their business.

We expect to collect Rs 3,000 million in revenues during 2004 with the introduction of this Economic Service Charge.

Deductions for Losses

Many businesses that make substantial profits do not pay taxes because they set off these profits against losses incurred during the year and brought forward from previous years. Commencing April 1, 2004, businesses can set off losses against the current year's total statutory income only up to a maximum of 35% of such income. Annex 1 provides further details of this tax policy change.

This measure is projected to result in Rs 800 million in revenue.

Partnership Income

I find that some partnerships currently distribute profits to fictitious partners and neither the partnership nor the partners pay tax on the profits earned. Commencing April 1, 2004 an up front tax of 10% will be imposed on the divisible profits and other income of all partnerships. This tax can be set off against the proportionate individual tax liability of each partner, up to a maximum of the tax payable, with no carry over provision.

We estimate that Rs 500 million will be collected through this measure.

Personal Income Tax

The tax free allowance for individuals will be increased to Rs 300,000 from the present Rs 240,000 and the subsequent tax slabs broadened.

The tax slabs for terminal benefits from all such benefits will be expanded so that the first Rs 3.5 million will be free of tax.

Details of these two measures, which

will substantially reduce the tax burden on individual tax payers and retirees, are given in Annex 1.

These measures are estimated to reduce revenue by Rs 300 million.

Value Added Tax

At present, VAT is charged at two rates of 20% and 10%. Seventy percent of the revenue collected by the Government from VAT comes from the 20% band, which includes a large number of items that are consumed by the average consumer. The high rate of 20% is, in some cases, a cause for tax evasion. Furthermore, the dual rate distorts prices in the economy and creates problems relating to VAT collection and refunds. The drop in revenue collection in 2003 is largely attributable to complications caused by the two band system. The upper rate of 20% and the dual band system acts as a deterrent to growth in the business and industrial sectors. Therefore, from January 1, 2004 we will move to a single unified VAT rate of 15%.

The turnover threshold of Rs 500,000 per quarter for payment of VAT will be raised to Rs 750,000 per quarter and the annual threshold will be increased to Rs 3 million. Certain changes will be introduced in the present refund system to simplify administration.

The new unified VAT rate will result in price changes, with the majority of items reducing in price. A publicity campaign will be launched to inform consumers, traders and retailers of the need to bring down prices in line with the reductions in the upper VAT rate from 20% to 15%.

With increased compliance resulting

from the lowering of the upper band and the elimination of problems relating to VAT refunds, the Government expects to collect Rs 2,000 million in additional revenue.

I have been particularly mindful of ensuring that the resulting increase of the lower band from 10% to 15% will not increase the cost of living. A detailed analysis has been done. Many essential items are exempt from VAT.

Hotel Room Tax

We had previously intended to introduce a hotel room tax of 10% of the room charge for all hotels classified as 3 stars and higher by the Ceylon Tourist Board. However, because of the large negative impact on the sector due to the recent political actions we have now decided to defer the imposition of this tax.

Levy on Cellular Mobile Subscribers

We are currently faced with large revenue leakages from the non payment of VAT on mobile cellular phones. An annual levy of Rs 300 per mobile phone subscriber will be imposed instead of VAT on the purchase of mobile phones, starting January 1, 2004. VAT will continue to be payable on the cost of calls. Annex 2 provides the details of the scheme.

It is estimated that the revenue yield in the first year will be Rs 600 million with increasing yields expected from the anticipated rapid growth of mobile telephony.

Elimination of Tax Exemptions

A number of tax exemptions have come into the Inland Revenue Act over a long period of time and the

original rationale for them no longer exists. Their removals will result in more equal treatment of income from different sources. I therefore propose to eliminate the tax exemptions listed in Annex 3 starting April 1, 2004.

This measure is estimated to result in increases in Government revenue by Rs 900 million.

Withholding Tax

Commencing January 1, 2004 the present exemption limit of Rs 9,000 per month or Rs 108,000 per year for withholding tax on interest income per deposit will apply to the total interest income from all deposits in any individual bank or financial institution made by a person or a corporate entity.

However, the withholding tax free limit will be raised to Rs 25,000 per month or Rs 300,000 per year in aggregate from all deposits of individuals whose sole or main source of income is interest from deposits. Such individuals must obtain a direction from the relevant Government authority for this purpose. This measure will assist pensioners from January 1, 2004.

Commencing on April 1, 2004, a 10% withholding tax will be levied on any annuity or royalty paid by any person or partnership in excess of Rs 50,000 in any month or Rs 500,000 in any year; and a 5% withholding tax on any management fee or similar payment. This withholding tax can be set off against the final liability to tax of the recipient.

The proposed changes in withholding taxes are estimated to increase revenue by Rs 500 million.

Tax Administration and Compliance

In order to widen the tax net and improve tax compliance I propose to introduce the tax administration and compliance measures listed in Annex 4, which includes measures relating to VAT. This will result in Rs 400 million in additional revenue.

Tax Expenses and Allowances

The changes in tax laws and procedures listed in Annex 5 will be introduced from April 1, 2004 which will result in the simplification of procedures, and the rationalisation of expenses and allowances for the determination of taxable income. This measure will yield Rs 300 million.

Duty Changes

Customs Duty/Excise Duty (Special Provisions)

As part of the continuing process of rationalising and simplifying customs duties, the duty bands will be reduced from 6 to 5. At the same time the present 20% surcharge on duty will be reduced to 10%. These changes will take place with effect from January 1, 2004. Excise Duty (Special Provision) on some items will also be adjusted at that time.

These measures are estimated to yield Rs 4 billion in revenue without adverse impact on the cost of living.

Excise Duty

The excise duty on beer has remained unchanged since 1998 while the excise duty on hard liquor has been increased several times. Therefore I propose to raise the excise duty, with

immediate effect, by Rs 5 per litre on beer with an alcohol strength of less than 5%, and Rs 10 per litre where alcohol strength is 5% or higher.

Large quantities of rectified spirits issued for industrial purposes are being grossly misused for the production of illicit liquor. Besides the health hazards to the public of consuming such illicit liquor, it has been estimated that on illicit liquor produced using one litre of rectified spirits the Government loses almost Rs 600 on taxes. I therefore propose to increase the excise duty on rectified spirits from Rs 36 per litre to Rs 200 per liter with immediate effect.

These changes will result in additional revenue of Rs 950 million.

Other changes in excise duty required to maintain revenue neutrality will be made at the time of introduction of the single VAT rate.

Depreciation for Calculation of Fiscal Levies

The maximum age of used motor cars that can be imported, without a licence, is at present three years. With a view to allowing Sri Lankans access to motor cars at a lower price I propose to increase this age to three and a half years.

Further, at present there are two separate depreciation tables, which are used to calculate depreciated values for determining VAT and duty on used motor cars and commercial vehicles. These depreciation tables will be changed in the manner detailed in Annex 6 to encourage the import of newer vehicles which are better from an environmental point of view and to reduce malpractices where motor cars have been classified

as commercial vehicles to take advantage of the higher depreciation rates applicable to the latter category.

Construction Machinery Imports

The maximum age of used construction machinery that can be imported will be reduced from 10 years to 7 years.

Fee Changes

License Fee on Kitul Palms

In the 2003 budget the Government introduced an excise tax of Rs 250 per tree on the tapping of kitul palms to provide a legal framework for granting of licenses for such tapping. There has been significant development in this industry since that time. To further encourage the sector the excise tax will be reduced to Rs 50 per tree with immediate effect.

Administrative Fees, Rents and Other Charges

Rationalisation and changes to administrative fees, rents on Government houses and buildings and other charges of loss making entities will be introduced to reflect realistic costs.

Rs 1,250 million in additional revenue and budgetary cost savings will result.

Turnover Levy on Tourist Board Registered Organisations

A 1% turnover levy was imposed on all organisations registered with the Sri Lanka Tourist Board in 2003. The General Sales Agents of airlines whose income is derived from the small percentage commissions they receive from the sale of air tickets will be exempt from this levy with effect from

January 1, 2004.

Developing Sri Lanka as a Regional Shopping Centre

We plan to introduce a scheme to make Sri Lanka a regional shopping centre for consumer electronic goods and high quality locally produced goods, such as ceramics. Under this scheme, foreign visitors to the country, who buy such goods from VAT registered retailers, will be entitled to a refund of the VAT paid on such goods, at the time of departure at the airport; and the duties on imported consumer electronics goods will be reduced to a nominal 3%. The scheme will be introduced early in 2004 and will have a beneficial revenue impact on the tourism sector.

The revenue foregone as a result of the duty reduction and VAT concession is estimated to be Rs 200 million.

Funds in Dormant Accounts with the Employees Provident Fund

Detailed analyses of EPF data reveal that there are large numbers of EPF accounts with low balances which have been dormant for long periods and which are very unlikely to ever being redeemed. Rs 4,500 million of such funds will be transferred to the Government as non-tax revenue with the provision to the EPF of a contingency guarantee, as necessary. A part of this amount will be used for the proposed unemployment benefit insurance scheme.

Increase in Salaries of Public Officers

The Tissa Devendra Commission

report published in mid-2002 carried out a detailed review of the public service salary structure and related issues. The trade unions and the opposition have been calling for the implementation of the recommendations in the report. Budgetary constraints, however, did not permit this. With the improvement of the economy we are now in a position to do so on a phased basis during the coming three years.

As part of this process, I will be appointing a Salary Review Committee to review the recommendations in the Devendra report to rationalise and amalgamate salary scales and to enhance selected scales because of anomalies or changes in circumstances. The Committee will also study options for rationalisation and closure of government entities. Its recommendations will be proposed for implementation with the next budget.

Meanwhile, commencing January 1, 2004 the Government will grant every public officer a monthly increase of 10% of his present salary or Rs 1,250, whichever is higher. This will also apply to employees of the Police Department, the armed forces and corporations.

Further benefits will follow in 2005 and 2006.

The Rs 1,200 interim allowance granted in 2000, and the Rs 1,000 or 10% of salary interim allowance granted in 2001, will be incorporated into the base salary of each scale by 2006. With this incorporation, lower level public sector employees will be on salary scales substantially higher than those recommended in the Devendra report. Consequently their pensions will also be higher. The

higher increments recommended in the Devendra report will also be introduced by 2006, in stages.

The rate of movement to the full Devendra scales will be subject to the condition on voluntary retirement that I will speak of shortly.

Where public sector or corporation employees in any individual sub-sector have been granted increases in salaries or allowances during the past three years, beyond the allowances granted to all public officers in 2000 and 2001, these increases will be set off to calculate the additional monthly amounts to be paid to such employees during 2004, 2005 and 2006. This process will eliminate the differences that have arisen between the salaries of such employees and public sector employees as a whole.

The cost of the 2004 salary increase is estimated to be Rs 12.5 billion.

Voluntary Retirement Scheme

We do not intend to implement the 30% reduction in the lower and middle grades of the public sector recommended in the Devendra report without a suitable safety net, since there will be hardships due to the resultant high unemployment. To overcome this problem we will introduce a Voluntary Retirement Scheme, or VRS, on January 1, 2004 with a suitably designed staggered compensation package which ensures that employees who accept the VRS will continue to receive monthly ex-gratia payments equivalent to their salaries and allowances.

An employee accepting the VRS will receive an up front payment equal to one year's remuneration, consisting of

the retiring salary and the 2000 and 2001 allowances. The employee will also receive monthly payments equal to his salary at retirement plus the 2000 and 2001 allowances until he reaches the retirement age of 55 years. Thereafter he will receive the applicable pension.

Employees will also be relieved of Rs 24,000 of outstanding distress loans at the time of retirement. Any balance outstanding on loans will be recovered from future monthly payments, with a one year grace period without deductions. Employees with no distress loans or loans less than Rs 24,000 will be paid equal monthly payments over two years so that they enjoy the same total benefit as those whose loans have been written off.

Our target is to reduce 100,000 public sector employees by 2004 and a further 200,000 by 2006 from the lower and middle income grades. Numerous indirect savings will accrue to the Government as a result.

The cost of the up front payment for the staggered compensation package is estimated to be Rs 8 billion, of which Rs 2 billion is already included in the voted budgetary estimates.

Increase in Pensions

It is only fair and just that pensioners be included in any revision in public sector salaries. Therefore pensioners will be granted a 10% increase in pensions from January 1, 2004. This is the largest increase granted to pensioners during the past 10 years.

This increase will cost the Government Rs 2.5 billion.

Further, the recently set up Pensions

Reform Office is presently studying various options to address anomalous situations where persons who have been retired for many years receive substantially smaller pensions than lower grade employees who retire later, because of salary scale changes that have occurred since the retirement of the first group.

Enhancement of Interest Rates on Deposits by Senior Citizens

In view of the difficulties faced by retirees and senior citizens because of the reduction in deposit interest rates, special deposit schemes have been introduced through the National Savings Bank and the two state commercial banks for senior citizens, where such persons receive a higher rate of interest on deposits.

Unemployment Benefit Insurance Scheme

The Government will provide Rs 1,000 million as initial funding for an unemployment benefit insurance scheme to be set up during the coming year. When fully operational the Scheme will be funded by contributions from employers and employees.

Housing Loan Scheme for Public Sector Employees

A loan scheme for public servants, in addition to the existing scheme, will be facilitated by the Government through the National Savings Bank for the purpose of construction, purchase, extension or repair of a house, purchase of land to build a house, or to repay a loan obtained from a recognised financial institution for housing purposes. The maximum

loan available will be Rs 1 million, the interest rate 9.5% per annum, and the repayment period a maximum of 20 years. Instalments for repayment will be recovered from the salaries and remitted to the Bank.

Increase in Fertilizer Subsidy

We propose to increase the subsidy given to fertilizer from Rs 2,000 million to Rs 3,000 million from January 1, 2004. This will mean that the total subsidy on a bag of Urea will increase from Rs 300 to Rs 450. Rs 3,000 million is the largest fertilizer subsidy granted in the last decade.

Agricultural Loan Relief for Farmers

The two state banks have, at the request of the Government, already instituted a scheme whereby farmers who have obtained loans from these banks for agricultural purposes and found it difficult to repay these loans due to crop failures and other valid reasons will be granted relief by the banks. Under the scheme farmers will be able to reschedule their loans for repayment over six growing seasons and the interest rate on the rescheduled loans will be a very attractive 4% per annum.

Garment Sector Productivity Improvement

A garment sector productivity improvement project will be implemented in 2004 through the Joint Apparel Association Forum. This will include a grant towards an international campaign to promote the industry and an interest free loan for the training and development of

production staff.

The cost of this project is Rs.150 million.

Agri-Business Development Fund

Continuing funding will be provided to the Agri-business Development Fund from which grants will be given to private sector entities that qualify, for the development of new technologies and practices in agriculture.

The cost of this programme is estimated to be Rs 100 million.

Development of the Milk Industry

Commencing January 1, 2004, incentive payments of Rs 2 per litre and higher will be provided to companies processing milk who collect a minimum 5 million litres of milk per year. The tariff adjustment will provide an additional incentive. These incentives will increase milk collection and develop dairy farming.

This programme is estimated to cost Rs 60 million.

The Government also intends to introduce a milk feeding programme for needy pre-school age children. A Committee will be appointed to study issues relating to the distribution of milk and lactose intolerance among children and make recommendations on how to implement a suitable milk feeding programme.

Rs 5 million has been allocated for the work of the Committee and for setting up a pilot programme based on the Committees initial findings.

Technology Improvement for Small and Medium Industry

A project to bring about technology improvements in small and medium enterprises will be implemented.

A total of Rs 1,000 million in funding has been budgeted for this project, of which sum Rs 900 million will be obtained from previous small and medium industry guarantee scheme funds collected by the Central Bank, which are no longer required for guarantee purposes.

Development of Rural Telecommunications

In keeping with the decision taken by the Economic Policy Committee of the Cabinet and the directive issued previously, starting April 1, 2003 telephone operators were required to pay a prescribed charge to the Vishwa Grama Fund. This fund will be used for the development of rural telecommunications.

Streamlining of Departmental and Statutory Funds

There are more than fifty statutory and departmental funds within various Government entities without adequate performance reporting or auditing and outside budgetary control. Income of these funds are from fees, charges, fines and donations and are estimated to be in excess of Rs 10 billion per year. These funds will be rationalised, merged and closed as appropriate. The funds will be brought under budgetary control and performance reporting and auditing systems will be introduced.

Visas for Foreign Nationals

At present the Government grants

citizenships to foreign nationals who meet specified criteria for investment in the country. This process is complicated by issues such as dual citizenship, which arise in this context. To avoid such complications, forty nine year long stay visas will be granted to non-residents who meet specified criteria for investment and deposits in the country.

Five year resident visas will be granted to professionally qualified persons in identified categories where a shortage of such professional skills exists in the country.

Budget Forecasts

Mr. Speaker, in Table 1 of Annex 7, I provide details relating to the expected budgetary performance for the year 2003.

Table 2 in the same annex provides a summary of the budgetary estimates for 2004. These estimates have been prepared on a conservative basis assuming that we will be able to realise only Rs 332 billion in revenue for the year. We have done so because of the uncertainties associated with the revenue impacts of some of the new tax proposals and the performance in revenue collection. If we are able to collect higher revenues, the additional amount will be spent on capital expenditure not identified or included in Table 2.

The fiscal deficit for 2004 is estimated to be Rs 138 billion, or 6.8 per cent of the projected GDP. The net domestic borrowing requirement for the year is projected to be Rs 65 billion.

Table 3 provides summary details relating to the gross borrowing requirements for 2004.

My Thanks

Mr. Speaker, the preparation of this budget has required much effort, which was compounded by the delay caused by the prorogation of Parliament. I have received assistance from many people in this effort. I would particularly like to thank the Hon. Deputy Minister of Finance and the officials of my Ministry for the inputs they have provided into the process. The staff attached to my office worked diligently and I thank them. The Hon. Prime Minister made a number of useful suggestions which have been incorporated into the budget. Trade chambers, professional organisations, trade unions and others forwarded suggestions for the budget, which we studied carefully and incorporated where appropriate. Finally, I wish to thank you, Mr. Speaker, and the staff of the Parliament who have arranged the logistics for today.

Conclusion

Mr Speaker, I concluded my last Budget Speech by asking that we be judged by the results that we deliver. As this House is well aware, on assuming office the challenges before this Government were both formidable and complex. Our legacy was an economy that had been battered and bruised. We have strived hard to resurrect it by adopting a three-pronged approach of promoting peace, macro economic stability and growth, and employment creation.

We have achieved much as shown by the figures I gave at the commencement of my speech.

On peace, we have advanced to a

point where we need considered yet decisive action to pursue the interest of all the people of Sri Lanka.

On macro economic stability, our record of delivery has been enviable. Fiscal prudence has brought the country lower inflation, reduced interest rates, a stable exchange rate and a strong external reserve position. Mr Speaker, we have also created the foundation to place the economy on a path of higher growth and employment generation. Both Sri Lankan and foreign investors have begun to show greater confidence in our economic prospects.

There is, however, much more that needs to be done. It is important that we build on the results that we have delivered. The challenge before us is to deliver the peace and prosperity that all the people of this country desire. We have constructed a strong foundation. The Government possesses the vision and the strategy, as well as the conviction and commitment to bring about a brighter future for this and future generations of Sri Lankans.

It is the Government's wish, and I have no doubt also that of all right thinking people of Sri Lanka, that no further political crises be created which will derail the existing process, and that political issues, if any, be sorted out by objective consultation and decision. This, the Nation is entitled to demand from all those who hold the reins of Government.

ANNEX 1: PROPOSED CHANGES IN TAX LAWS

1.1 Tax slabs of individuals

With effect from the Year of Assessment 2004/2005

- a) The tax free allowance to be increased from Rs.240,000 to Rs 300,000.
- b) The tax slabs for income tax to be widened as follows

First Rs 300,000	Nil
Next Rs 240,000	at 10%
Next Rs 240,000	at 20%, and
Balance	at 30%.
- c) Tax slabs for terminal benefits from employment (provident fund contributions, retirement gratuity and compensation for loss of office) to be revised as follows:

First Rs 3.5 million	Nil
Next Rs 500,000	at 5%,
Next Rs 500,000	at 10%, and
Balance	at 15%.

The methodology for calculating 'Retirement Gratuity' for tax purposes will also be reviewed.

1.2 Losses incurred in any trade, business, profession or vocation

With effect from April 1, 2004, losses incurred in any year or losses brought forward from previous years, by any person, will be available for set off against income earned in any year to a maximum limit of 35% of the total statutory income in that year.

All current limitations on the carry forward of losses will be removed. The existing provisions with regard to the carry back of losses, and to special conditions for certain sectors, including losses on horse racing, leasing, FCBU onshore transactions will also be removed. Capital losses will be abolished with effect from April 1, 2004.

Further, losses generated by way of intra group transactions, which have no economic substance will be disallowed.

ANNEX 2: LEVY ON CELLULAR MOBILE SUBSCRIBERS

The Government will impose an annual levy of Rs.300 with effect from January 1, 2004 on every cellular mobile subscriber (defined as the holder of a telephone number starting with the prefix 07 as specified in the National Numbering Plan and which is capable of receiving calls, even if not capable of originating calls for the entirety of the 12 month period). The holders of the relevant number ranges beginning with 07, namely the mobile operators licensed under section 17 of the Sri Lanka Telecommunications Act No. 25 of 1991 as amended, shall collect the

annual levy and remit it to the Telecommunications Regulatory Commission (TRC) in the following manner:

- a) In respect of all existing mobile subscribers, within thirty (30) days from the commencement of the levy on 1 January 2004;
- b) For any new subscriptions initiated on or after January 1, 2004, within seven (7) days of the end of the quarter within which the services have been initiated;
- c) For any subscriber referred to in categories (a) and (b) above, at the expiry of every 12 month period, within seven (7) days of the end of each quarter within which such 12 month period expires.

Each operator shall submit a summary of the total of active mobile subscribers as defined above and the number of disconnected subscribers on a quarterly basis together with the payment of the aggregated levy to the TRC within seven (7) days of the end of the quarter. Payment with regard to item (a) above together with a summary of subscribers shall be submitted to the TRC on or before February 7, 2004.

The TRC shall submit a payment for the total levy collected with a consolidated statement of the information referred to in the previous paragraph, to the Treasury, within fourteen (14) days of the end of the quarter. Payment with regard to item (a) above, together with a summary of the subscribers, shall be submitted to the Treasury on or before February 15, 2004.

ANNEX 3: RATIONALISATION OF TAX EXEMPTIONS AND RELIEFS

- 3.1 With the exception of international and multilateral organisations, other income (excluding donations and grants) of institutions approved under section 8(a) of the Inland Revenue Act, in excess of Rs. 200 million will be liable to tax at 10% with effect from April 1, 2004. Dividends and Interest earned by such institutions will continue to be liable to the withholding tax.
- 3.2 Any exemption currently available on Dividends declared by companies will be withdrawn with effect from April 1, 2004. with the exception only of those declared by companies which have entered into an agreement with the Board of Investment or which qualified for exemption under the relevant sections referred to in section 11(f) of the Inland Revenue Act before 6 November 2002, which will be governed by the terms of those agreements and provisions.
- 3.3 Profits and income earned from the re-export of stones, metal, petroleum, gas or other items as have been approved that have been imported; fees received by employment agencies from the Sri Lanka Bureau of Foreign Employment; and from the operations and maintenance of facilities for the storage of goods and commodities brought into Sri Lanka for re export will be liable to tax at 10% with effect from April 1, 2004.

- 3.4 Profits earned from the sale of shares (including rights, bonuses and warrants and shares in BOI companies) that are issued by any company will be liable to tax at 15% with effect from April 1, 2004.
- 3.5 Off shore transactions of the Foreign Currency Banking Unit of any Bank operating in Sri Lanka, which had previously been exempted, will be liable to tax at 20% with effect from April 1, 2004 (Year of Assessment).
- 3.6 The exemption granted to any royalty payment made to a non resident person will not be available to any company that signs an agreement with the Board of Investment on or after April 1, 2004.
- 3.7 The exemption granted under section 21 for the construction and sale of houses will be removed with effect from April 1, 2005, since this activity is now covered under section 21C.
- 3.8 A new tax regime will be introduced with effect from the Year of Assessment 2004/05 for any person who has obtained a development licence under the Petroleum Resources Act, whereby the operation would be liable to tax at 15%. Any foreign based service sub contractor would also be liable at 15%.
- 3.9 Other amendments would be made to the existing provisions to bring them in line with the incentives available under the Board of Investment Law and to rationalise the existing reliefs under the Inland Revenue Act with effect from April 1, 2004:
- 3.9.1 i) Animal husbandry; deep sea fishing; manufacture of machinery; and export or deemed export of services to be included as "Specified Services" for section 21A of the Inland Revenue Act;
ii) The minimum investment to qualify under this section to be increased to Rs.10 million for a new company and Rs.50 million for an existing company;
- 3.9.2 i) Application of relief available under section 21A, for investments in excess of Rs.250 million to be limited to pioneering projects;
ii) Where the investment is in excess of Rs.1 billion, relief to be aligned with that available under section 21B;
- 3.9.3 i) The upper limit of Rs.50 million imposed for relief available for Small Scale infrastructure under section 21C to be removed;
ii) Redevelopment of housing schemes to be included for relief under section 21C
- 3.9.4 Exemption available under section 21D to any undertaking involved in Research and Development to be limited to the income earned from that activity only;
- 3.9.5 Relief under sections 21F and 21G for expansion of existing businesses would be extended to 31 December 2004; and
- 3.9.6 In order to include other benefits available under the BOI law, to provide relief under the Inland Revenue Act for-
- a. the acquisition of assets of existing undertakings involved in large scale infrastructure projects,

- b. regional operating headquarters for specified activities; and
- c. export trading houses within a Free Trade Zone.

ANNEX 4: MEASURES TO IMPROVE TAX ADMINISTRATION AND COMPLIANCE

4.1 Non payment of taxes

Currently interest and penalty are combined into one charge for non payment of taxes. With effect from April 1, 2004, the penalty for non payment to be charged at a maximum of 10%. The penalty to be charged on the following basis:

- a. Where persons have accepted liability and not paid: a 5% charge with effect from the date on which the tax is due and an additional 1% per month thereafter.
- b. Where taxes have been in dispute: a 10% charge on the due date
- c. Persons who have not filed returns: a 10% charge with effect from the date on which payment is due under an Assessment

Interest on taxes in default will be computed as follows and may not be waived –

1 st 12 months	at 1.0% per month or part thereof; and
thereafter	at 2.0% per month or part thereof.

Where the tax payable by any person has been in default for more than 3 years, such person could be liable to a term of imprisonment of a period not exceeding 3 months.

4.2 Payment under the self assessment scheme

For payment of income taxes under the self assessment scheme, the 1st and 2nd instalments of any year may be estimated on the basis of the tax payable for the previous year of assessment or the year immediately preceding that year of assessment. Any person, whose income had previously been exempt from income tax and becomes liable on the expiry of the tax holiday, will have to estimate liability on the basis of the income earned in the preceding years that had been exempted from tax.

4.3 Registration with the Inland Revenue Department

All companies and partnerships and any other businesses that are registered with the Registrar of Companies or the Registrar of Business Names shall be required to register with and open a file with the Department of Inland Revenue and file an annual return of income together with the relevant statements of accounts for each Year of Assessment commencing from the Year of Assessment 2003/2004, whether or not they are liable to pay any tax.

A scheme for submission of confirmation will also be formulated.

All persons who are liable to deduct and remit any Withholding Tax under the Inland Revenue Act will be required to register with the Department and furnish

monthly returns along with the payment.

The existing regulations for the submission of information to the Department of Inland Revenue will be updated.

4.4 VAT

In order to encourage BOI companies that are in the business of providing or producing exempt supplies, to purchase their capital items at project implementation stage, from local manufacturers, a negative list of items that will not be entitled to any exemption from VAT at the point of import will be introduced.

Any refund of excess input tax would be made after 6 months from the end of the taxable period other than for zero rated suppliers and new businesses registered under Section 22(7) of the VAT Act.

ANNEX 5: COMPUTATION OF TAXES

5.1 Rationalisation of the determination of statutory income

a) Economic Depreciation

As proposed in the last budget economic depreciation will be introduced with effect from April 1, 2004.

IT equipment and accessories, including software	25% per annum
Vehicles and furniture	20% per annum
Plant and Machinery	12½% per annum
Intangible Assets (other than goodwill)	10% per annum
Bridges, railways, reservoirs, electricity or water distribution lines and toll roads	6 2/3 % per annum
Buildings *	6 2/3 % per annum

*Buildings to also include any industrial or hotel building that has been purchased from any person who has used that building in any trade or business.

Roll over relief to be provided on any profit or income on the disposal of an asset that has been depreciated and is replaced either 6 months prior to or 6 months after the disposal of such asset.

At the time of disposal of any of the above assets, the total sale proceeds to be taken into consideration in determining the profit or loss on disposal.

b) Leased Assets

In the books of the lessor, where the leased item is subsequently transferred to the lessee, the transfer will be valued at the deemed market value as at the date of transfer.

In the books of a lessee, where any asset has been leased and the lease rental has been allowed as a deduction either in part or in full, then any proceeds on the subsequent sale of that asset, after acquisition, would be treated as business income.

c) Costs incurred by a business on behalf of any employee

The current provisions re the ability to claim the following expenses will be amended with effect from April 1, 2004

- i) the cost of providing a residence or assets to be used at the residence of any employee;
- ii) domestic and private expenses of partners and other employees of any business;
- iii) any property, movable or immovable, given by the employer to the employee at a price that is less than market value;
- iv) any loan or other advance or credit given to an employee and subsequently written off in the books of accounts;
- v) Where any employee is provided with more than one vehicle, any expenditure incurred in respect of the additional vehicle(s). This same provision will also apply to any vehicle provided to any non executive director or other person, who is not an employee of the company;
- vi) Any additional payments made by an employer towards a super annuation fund or scheme to be allowed as a deduction if certified by an actuary.

d) Management Fees

The current restriction on the payment of management fees to be removed.

e) PAYE

Where any director or chairman of the Board of Directors of any company receives any remuneration which is not included in the payroll for purpose of computing PAYE in accordance with the Inland Revenue Act, then a 10% tax to be charged on such remuneration which amount may be set off against the ultimate tax liability for that year of that director but which is not refundable.

Where any payment is made to a non executive director of the company, a 10% tax to be charged on the total remuneration payable by the company to such non executive director which may be set off against his ultimate tax liability for that year but which is not refundable.

Valuation for benefits provided to employees to be amended as follows:

Private use of motor car, jeep or van	Rs.7,500 per month
Private use of a motor cycle	Rs.2,000 per month

Residence to directors or senior executives Rs.120,000 per annum.

(Senior executive to be identified as an employee drawing a monthly base remuneration in excess of Rs.50,000).

5.2 Assessable and Taxable Income

a) Amendment to the Inland Revenue Act with regard to the Return of Income

The Inland Revenue Act will be amended to remove the computation of Assessable Income in the Return of Income. Only Statutory Income and Taxable Income will be retained.

b) Computation of Taxable Income

The value of donations, expenditure on housing, provident fund contributions and insurance premia, which may be claimed to arrive at Taxable Income to be revised as indicated below:

- i) Donations made to the Government, Government Funds and Funds of the Local Government, Provincial Councils and Universities to unlimited value (if in cash) or to a limit of Rs 2 million (if in kind) in any year, with the ability to carry forward any surplus;
- ii) Donations in cash to any approved charity: contributions not exceeding 12% of salary to any approved Provident Fund: Premia on life or medical insurance – to a maximum of Rs.75,000 in any year (all combined) with any surplus not being available to carry forward;
- iii) For any individual (subject to other provisions currently in force) –
 - a) expenditure incurred in repayment of any approved housing loan with any surplus not being available to carry forward; and/or
 - b) any expenditure incurred, out of his or her own funds for the construction of a first house with the ability to carry forward any surplus for a maximum of 9 years to a maximum of Rs.100,000 in any year;
- iv) 50% of the cost of any investment, not less than Rs.500,000, in new shares of a Venture Capital Company, which is exempt from income tax, with any surplus not being available to carry forward;
- v) any balance outstanding on the Investment Tax Allowance to be available for set off only until 31 March 2005;
- vi) The amount to be claimed in respect of items (ii), (iii) and (iv) will each be subject to a further limit of 10% of the Statutory Income.

5.3 Other provisions to simplify and rationalise the existing law.

Sources of income to be extended to include winnings from lotteries, betting and gaming.

The definition of “business” to include forestry,

Any rental income earned by a company to be treated as business income

ANNEX 6: PROPOSED DEPRECIATION TABLES USED FOR CALCULATION OF FISCAL LEVIES UNDER THE CUSTOMS ORDINANCE

Period of Use	Depreciated FOB Value	
	Motor Cars	Commercial Vehicles
Less than or equal to 6 months	Nil	Nil
More than 6 months and less than or equal to 1 year	90%	90%
More than 1 year and less than or equal to 1½ years	85%	80%
More than 1½ years and less than or equal to 2 years	80%	70%
More than 2 years and less than or equal to 2½ years	77.5%	65%
More than 2½ years and less than or equal to 3 years	75%	60%
More than 3 years and less than or equal to 3½ years ¹	72.5%	55%
More than 3½ years and less than or equal to 4 years	70%	50%
More than 4 years and less than or equal to 4½ years	65%	45%
More than 4½ years and less than or equal to 5 years ²	60%	40%
More than 5 years and less than or equal to 5½ years	55%	35%
More than 5½ years and less than or equal to 6 years	50%	30%
More than 6 years and less than or equal to 6½ years	45%	25%
More than 6½ years and less than or equal to 7 years	40%	-do-
More than 7 years	35%	-do-

¹Threshold of import licence requirement for Motor Cars

²Threshold of import licence for Commercial Vehicles

ANNEX 7: BUDGET FORECASTS**Table 1: Expected Budget Outturn 2003 (Economic Classification)**

	Rs Billion	As a % of GDP
Total Revenue	292	16.3
Tax Revenue	251	14.1
Non- tax Revenue	41	2.3
Total Expenditure and Net Lending	-432	-24.2
Recurrent Expenditure	-343	-19.2
Public Investments	-90	-5.0
Restructuring	-5	-0.3
Other	5	0.3
Current Account Deficit	-51	-2.8
Overall Budget Deficit	-140	-7.8
Financing	140	7.8
Foreign Grants	9	0.5
Net Foreign Borrowings	37	2.1
Net Domestic Financing	80	4.5
Divestiture Proceeds	14	0.8
Debt/GDP Ratio		100.1

Table 2: Budget Outturn 2004 (Economic Classification)

	Rs Billion	As a % of GDP
Total Revenue	332	16.4
Tax Revenue	293	14.4
Non- tax Revenue	39	1.9
Total Expenditure and Net Lending	-469	-23.2
Recurrent Expenditure	-358	-17.6
Public Investments	-108	-5.3
Restructuring	-10	-0.5
Other	6	0.3
Current Account Deficit	-26	-1.3
Overall Budget Deficit	-138	-6.8
Financing	138	6.8
Foreign Grants	10	0.5
Net Foreign Borrowings	50	2.5
Net Domestic Financing	65	3.2
Divestiture Proceeds	13	0.6
Debt/GDP Ratio		94.9

Table 3: Gross Borrowing Requirement – 2004

		Rs. Billion
Total Receipts (excluding borrowings)		366
Revenue	343	
Divestiture Proceeds	13	
Foreign Grants	10	
Total Payments		-691
Recurrent Expenditure	-352	
Capital Expenditure	-140	
Debt Repayments	-196	
Advance Accounts	-2	
Gross Borrowing Requirement in Terms of Book Value		325
Add:		
Adjustment for on lending to Private Sector and Debt Restructuring		25
Total Gross Borrowing Requirement in Terms of Book Value		350