

EXECUTIVE SUMMARY

Current vision of the Government of Sri Lanka is that becoming a rich country by 2025. For this scramble journey, financial stability is a fundamental requirement as per the economic concepts. Among three main Government revenue generation agencies, the Department of Inland Revenue (IRD) is one of the dominant party throughout the history from 1932. Value Added Tax on Financial Services (VAT on FS) plays a significant role in the contribution of revenue generation in IRD. Due to several tax calculation issues from the establishment of VAT on FS in 2003, real payable tax has not been collected by IRD and payments have been dragged by taxpayers on appeals. Through this study, it was intended to find out the burning issues of VAT on FS and propose some achievable solutions for those identified issues. Methodology of the study was established that after identification of burning issues by using several analytical techniques, solutions were proposed through a comprehensive literature reviewing regarding the global mechanism for calculation of VAT on FS.

Current situation of the Department of Inland Revenue was analyzed through a SWOT analysis and it was identified that tax legislation loopholes are available in every tax legislations and occurring considerable tax loss on those issues. Further, as the threats it was identified that confidence is given to taxpayers to emphasize the weakness of current system in appeal hearings and tax evasion is getting high on legislation loopholes. When analyzing of VAT on FS current operation, it was identified that significant revenue loss has been occurred on the issues in the two areas of total value addition and attribution of financial value addition. Under the 3W & 1H analysis, it could be identified that considerable amount of issues have been raised on the tax calculation process. It was further identified that, if those areas are streamlined, smooth operation could be expected in VAT on FS tax type. Ten internal opinions were obtained from subject experts on the discussion and through a feedback form. Key problem was identified that VAT on FS calculation mechanism is significantly out of the fundamental concepts of value addition and complexity has been formulated in the application of relevant legislation in chapter IIIA of VAT Act due to continues changes of its contents.

A comprehensive analysis was conducted through a systematic literature review for both local practice of VAT on FS and global practices. Every year from 2003 except the year 2010, legislation for VAT on FS was changed continuously due to several administrative issues such as tax calculation issues, changes of tax rates, Changes of tax scope etc. Under the global practices, application of VAT on FS was studied in China, European Union, New Zealand, and India. It was further understood that the addition method is an accounts-based method. Various kind of concepts in relation to VAT on FS were analyzed for finding out best alternative calculation mechanism. For conducting of the project, the study framework was formulated based on the theoretical analysis.

Four project objectives were formulated for conducting of the project. Further, four project components were constructed and first one was the current situation analysis. It was understood that payment of VAT on FS has been reduced around 10% to 15% when comparing with total value addition of the banking sector in Sri Lanka. Three and two sub-components could be identified for the modification to the calculation mechanism of total value addition and changing of parameters in recognizing of financial turnover respectively. Credit method was reintroduced by eliminating negative effects of the previous provisions. The Detailed action plan was prepared and it is intended to conduct the implementation works from 01/09/2018 to 31/03/2019. Resource allocation, Cost benefit analysis and projected output and outcome were identified under the project. The detailed project would assists for the effective implementation of the project.

Emoluments were reconstructed by introducing of workers' remuneration as emoluments. All the tax payments were defined as part of the value addition. Provisions other than the economic depreciation and impairment on doubtful debts were defined as part of value addition. VAT excluded supplies were included to the Section 25C (5) of VAT Act as part of zero value addition category. By amending of Section 25F of VAT Act, definitions of financial services were rectified. Schedule 03 of VAT on FS Gazette Notification was proposed for the identification of real turnover elements. Strong recommendation was given by stating that VAT on FS calculation mechanism must be streamlined based on the said three key areas.