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BUSINESS TURNOVER TAX SYSTEM
IN SRI LANKA

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ABSTRACT

The business turnover tax was introduced in Sri Lanka over a decade ago as a measure both to recoup the declining revenues of the government and to provide additional revenues needed for development. Although the business turnover tax constitutes a major source of government revenue, comparatively little effort has been made so far to examine the subject in depth. This study therefore seeks to make a critical and more intensive survey of the operation of the business turnover tax and its role in the developing economy of Sri Lanka.

After a few introductory remarks on the nature and history of sales taxation, Chapter I examines in the historical perspective the evolution of the business turnover tax in Sri Lanka. The history of business turnover taxation is also traced upto 1976 with emphasis on the important revisions made in the law. The focus of Chapter 2 is on the role of business turnover tax as an instrument of development policy. The Chapter seeks to make an appraisal of the goals pursued by the government in the sphere of economic development and the effect of business turnover tax on the attainment of these objectives. In Chapter 3 the revenue importance of the business turnover tax and the trends in the revenue yield are examined. The dual structure of the economy, its vulnerability to fluctuations in international prices and the consequent decline of export and import revenues are briefly traced while the fiscal importance of the business turnover tax is analysed in the context of the bleak prospects for any expansion of revenues through other sources.

Chapter 4 analyses the manner in which the burden of the business turnover tax is distributed among the various sections of the community and the measures introduced to

reduce its regressivity. Chapter 5 deals with the business turnover tax administration focusing attention on the general administrative structure, the self-assessment system and the collection and enforcement procedures. Finally, with the current focus of interest in the value-added tax as an alternative to business turnover tax, the concluding Chapter analyses the feasibility of substituting a value-added tax in Sri Lanka and the potential implications of such a change.

CHAPTER 1

EVOLUTION OF THE BUSINESS TURNOVER TAX SYSTEM

Classification of Taxes

An appraisal of various classifications of taxes prescribed by fiscal economists would point to the considerable lack of unanimity that exists on an appropriate classification acceptable for all circumstances. However, the distinguishing feature of such classifications is the stress laid on the tax base, the underlying emphasis being either on the nature of the tax base, the presumed effects and the incidence of the tax or the relationship between the tax base and the rates of tax. A distinction is usually made between taxes on persons and on business organisations. In such a dualistic classification, stress is placed on whether the individual or the business organisation is the legal taxpayer. A more realistic approach seems to be the classification which focuses on whether the tax base is income, wealth or commodity transaction. Taxes are also often classified as progressive or regressive, thus establishing a relationship between the tax base and the rate of tax. Other fiscal theorists suggest a distinction between "direct" and "indirect" taxes. The assumption behind this terminology is that while the burden of direct taxes falls on the statutory taxpayer, that of indirect taxes would be shifted from the statutory taxpayers to others. The validity of this proposition has been frequently questioned in that some of the so-called direct taxes could be shifted while the burden of certain indirect taxes would tend to remain with the statutory taxpayers. Nevertheless, the "direct - indirect" terminology seems to be the single most widely used classification today.[1] In this classification, customs duties, excise taxes and sales taxes are traditionally referred to as forms of indirect taxation.[2]

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1. International Encyclopedia of the Social Sciences Vol.15, p.5
2. John F. Due, Indirect Taxation in Developing Economies, p.1.

The Concept of Turnover Taxation

A sales tax may be defined as a levy imposed on the sale or on some transaction, act or operation incidental to such sale (such as production, transfer or delivery) of a wide range of goods or commodities. The tax may be imposed on physical goods only or it may be extended to cover commercial and professional or other personal services. Sales taxes may be distinguished from excise taxes. It is a distinction based on the scope of coverage. Excises refer to a selective tax on specified commodities or groups of commodities such as tobacco products and alcoholic beverages enumerated in the law. A sales tax may also be distinguished from a business or license tax measured by gross receipts and usually termed license charges or fees "which is regarded as a charge for the privilege of carrying on business activity." [3]

Sales taxes may be classified into two major groups - the single-stage and multiple-stage sales taxes. The single-stage tax is imposed on a commodity at only one stage in the production and distribution process. There are three possible levels at which a single-stage tax could be applied.[4] It may be imposed on the sale of finished products by the manufacturer, on the last wholesale transaction whether made by the manufacturer or wholesaler or on the retail sale to the final consumer. "A general multiple-stage or multi-point sales tax, applying to sales at all stages of production and distribution, is generally known as a turnover, or transactions tax or cascade tax."[5] The tax is assessed on the total consideration paid without allowance for any values previously taxed. An alternative approach of sales taxation of more recent origin is the value-added tax which is a hybrid of the two principal forms. The value-added tax is applied to commodities at each level of production and distribution but the tax falls not on total sales value but only to the "value-added" at each stage in the production and distribution channels.

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3. John F. Due, Sales Taxation, p.3.
4. Ibid., p.4.
5. John F. Due, Indirect Taxation in Developing Economies, pp.117-118.

There are instances of the existence of sales taxes in ancient Rome, and in France and Spain during the medieval period. The Spanish sales tax "alcabala" first enforced in the local communities during the thirteenth century and introduced on a national scale in 1342 remained in existence for nearly five centuries. France too, had a long experience with various forms of sales taxes. However, the modern concept of multiple-stage turnover taxation was developed in Europe during and after World War I. It was the financial problems arising out of World War I which focused the attention of various governments on sales taxes as a dynamic source of revenue.

In 1918, Germany enacted the umsatzsteuer, a turnover tax to cover virtually all transactions. Despite various criticisms and suggestions for reform, in terms of revenue yield, the tax continued to be the most significant single tax in the country's revenue system till the formation of the European Economic Community in 1968.

In 1917, France introduced a "payments tax" on all retail sales which was superseded by a general turnover tax in 1920. The basic nature of the tax remained unchanged till 1936 when it was replaced by a "production tax" being essentially a single stage manufacturers' sales tax.[6] The financial pressures of War and search for increased revenues led to a revival in 1939 of the original turnover tax. The comprehensive set of reforms of 1948 introduced the fractional payments technique[7] of collecting the manufacturers' sales tax, which greatly facilitated the transition to value-added tax for which France opted in 1955.

The other original member countries of the European Economic Community also imposed a general turnover tax of the cascade type. The turnover taxes that were introduced in Belgium Italy, Luxembourg and Netherlands differed widely from one another in scope and technique. Nevertheless, they all shared a common feature in that they were all multiple-stage taxes.[8]

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6. Clara K. Sullivan, The Tax on Value-added, p.67.

7. Each manufacturer paid tax on his sales but was allowed to deduct from his tax liability the amount of the tax borne on certain purchases.

8. Netherlands replaced the turnover tax by a value-added tax in 1969, Luxembourg in 1970, Belgium in 1971 and Italy in 1973

Several developing countries also make use of the turnover taxes as a major source of government revenue. Sales taxes introduced by most of the Latin American countries during the period between the two World Wars were of the cascade type. Ecuador, Uruguay, Argentina and Cuba initially employed cascade taxes but later replaced them with manufacturers' sales taxes or value-added taxes. Cascade taxes were introduced in Peru in 1952 and in Bolivia in 1957 but both countries subsequently opted for single stage turnover taxes. The turnover or the "cascade" tax has been adopted in a number of Indian states, in the Republic of Korea and some African states. Sri Lanka too decided in favour of a multi-stage turnover tax in 1964.

History of sales taxation in Sri Lanka dates back to the year 1955. The Taxation Commission of 1955 considered in detail a proposal to introduce a sales tax in Sri Lanka.[9] The Commission contemplated the adoption of a retail form of sales tax but it recommended that " a comprehensive survey should first be made of the actual pattern of retail trade obtaining in various parts of the Island "before a sales tax is introduced.[10] Thus, as proposed by the Taxation Commission it was announced that a Committee would be set up "to investigate the fields in which sales taxes may be successfully introduced."[11] But, the People's United Front (Mahajana Eksath Peramuna) which came to power after defeating the ruling United National Party at the General Elections of 1956 failed to initiate any action on these proposals.

However, the new government with its strong emphasis on planned economic development did formulate in 1959, a Ten Year Plan of development for the country. The Ten Year Plan while reiterating the need for extra taxation to raise the additional revenues needed to implement its proposals, suggested

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9. Report of the Taxation Commission, Sessional Paper XVII - 1955, pp.320-324

10. Ibid., p.324.

11. Budget Speech 1955-56, Minister of Finance, p.17.

that it could come by way of taxes on incomes and taxes on turnover or commodities. Although the Plan did not advocate the implementation of any particular measure, it focused attention on the desirability of a system of commodity taxes "in which high rates apply to goods consumed in relatively large amounts by the rich and low rates to goods consumed in relatively large amounts by the poor."[12] But, political instability and frequent changes in governments which characterised the period 1959-60 cast into limbo the adaptation of the proposals of both the Taxation Commission and the Ten Year Plan.

After the July 1960 General Elections, the new Sri Lanka Freedom Party government examined the feasibility of enacting a retail sales tax as envisaged by the Taxation Commission. However, it was reluctant to introduce such a form of tax due to the entailing administrative constraints but preferred a modified form which would be payable at the point of wholesale.[13] Accordingly, a sales tax was introduced for the first time in Sri Lanka by Finance Act No.65 of 1961 to take effect from 1st August, 1962.[14] The tax was imposed on "sales value" arising in respect of transactions with regard to goods produced in or imported into Sri Lanka. The imposition covered all goods except those specifically exempted from tax liability.[15] The tax was designed to fall on the last wholesale transaction at the point when goods are sold by a manufacturer or wholesaler to a retailer. In the case of goods imported by consumers or retailers, the tax was levied at the point of consumption on the value hypothetically fixed by law as "the price that article would fetch on a sale in the open market."[16] The rate of tax was to be 7½ per cent.

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12. The Ten Year Plan, p.116.
13. Budget Speech 1961-62, Minister of Finance, p.24.
14. Finance Act No.65 of 1961, Part IV.
15. Ibid., Section 24(1).
16. Ibid., Section 28(a).

For sales tax purposes, traders were required to register themselves with the Department of Inland Revenue.[17] Sales tax was to be recovered on the sales made by a registered trader to a person who was not a registered trader. If a registered trader sold to another registered trader sales tax was not payable on such transactions. However, when the last registered trader in a chain of transactions sold to an unregistered person, sales tax was payable by such last registered trader. A sale by a person who was not a registered trader to any other person did not attract sales tax. Every registered trader was to be issued a card on which he was able to purchase goods free of sales tax from other registered traders. Importers too had to produce their registration certificates before the Customs authorities to claim exemption from sales tax. All registrants were to maintain two separate bill books, one for articles liable for tax and the other for articles exempt from tax.[18] At the end of each month, every registered trader was required to make a return to the Inland Revenue Department, showing the total sales of all articles during the month, total sales of exempt articles and total sales of articles subject to sales tax sold to other registrants, diplomatic representatives and other persons who are not liable to sales tax.

The government maintained that it was compelled to adopt this fiscal measure in order to finance its economic development programme. Although the government was aware that the tax would cause considerable hardships to the lower income groups, it was emphasised that "economic development on the scale contemplated by the government and which was necessary in order to maintain even the existing standards of living could not be financed without some contribution from the country as a whole."[19] The main criticism of the tax was based on the premise

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17. Under the sales tax, importers whose annual imports exceeded Rs:25,000 in value, local manufacturers whose turnover exceeded Rs:25,000 a year and traders whose sales exceeded Rs:250,000 a year were required to register.

18. For exempt articles under the sales tax, see <u>Appendix I.</u>

19. <u>Press Communique on the Sales Tax</u> issued by the Ministry of Finance. Ceylon Daily News, October 18th 1961.

that although the tax was intended to be charged at the wholesale level, it would doubtlessly be transmitted down the line to the consumer who will ultimately have to face the burden of the tax.[20]

During the two days of its operation, it was evident that the effect of it had been quite different from what the government intended. Price increases totally unrelated to the 7½ per cent had been made by many trading establishments. Many traders although not liable to the sales tax were charging an additional 7½ per cent on their prices from the consumers. Prices of a wide range of commodities had been increased without any justification on the pretext of the sales tax.[21]

The rise in prices was partly the result of the haste and lack of preparation that preceded the introduction of the tax. Although a sales tax was envisaged in the Budget Speech of 1960-61 and provision made in the Finance Act of 1961, during the twelve months that elapsed, adequate preparations had not been made administratively about its levy. The new tax came under the supervision of the Inland Revenue Department but little effort had been made to make the tax intelligible or workable. There was a great deal of confusion in the public mind, among both the traders and consumers regarding the incidence of the tax. A large number of traders had not received their fegistration cards on which they could purchase goods free of sales tax from other registered traders. Sales tax inspectors had not been appointed and thus there was no effective machinery available to safeguard the consumers from possible exploitation by unscrupulous traders. No efforts were made to ensure that price increases were only to the extent decreed by the tax.

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20. Bernard Soysa, M.P. Hansard Vol.43 No.16, 17th August, 1961 Columns 2718-2719.

21. Communique on the sales tax issued by the Ministry of Finance, Ceylon Daily News, 3rd August, 1962.

From the moment of its imposition, the hostile reaction of the people who were already feeling the heavy burden of cost of living began to manifest itself. The intolerable addition to the cost of living evoked widespread and intense resistance of the workers, peasants and the masses who by their consolidated protests made the government to withdraw the tax. The public heaved a palatable sigh of relief when the tax was withdrawn after those "two black days" of August, two days of incredible bungling which made a fiasco of the sales tax.[22]

Despite the widespread opposition generated by the introduction of a sales tax, the government did not abandon its interest in this form of tax. In 1963, under a new Finance Minister, the government did introduce a variant of sales tax - the business turnover tax, so termed more by design than by accident, in order to obliterate from the public mind the unpleasant memories of the earlier tax.

The business turnover tax wqs enacted in Sri Lanka by the Finance Act No.11 of 1963 to become effective from 1st January, 1964. It was a product of the financial necessities arising from the imposition of a rigorous import control policy by the government.[23] The resulting sharp reduction in import duty revenues and the policy of import substitution, generated pressures for greater domestic taxation. "As more and more goods are produced within the country itself, the tendency to subject such goods to specific or general consumption taxes manifests itself."[24] Thus, the business tunnover tax was introduced as a compensatory measure, "in order to recoup from the taxation of domestic manufactures, at least part of the revemue lost through the fall in imports."[25] The apparent

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22. "Two Black Days" Editorial, Ceylon Daily News, August 4th, 1962
23. For a detailed analysis, see Chapter 3.
24. Report of the Taxation Inquiry Commission, Sessional Paper X - 1968, pp. 143-144.
25. Budget Speech 1963-64, Minister of Finance, p.51.

success of turnover taxation as popular revenue raisers both in socialist countries and many capitalist countries in Europe had a considerable impact on Sri Lanka in deciding to recourse to this new form of taxation.[26]

Coverage: The tax enacted by the Finance Act No. 11 of 1963 was basically a multiple stage tax. It applied to every person who carried on in Sri Lanka, the business of a manufacturer or any other business and was imposed in respect of the turnover of such business.[27] The imposition in its terms covered any trade or vocation but the coverage excluded the services of the professions, the services rendered by bankers, financiers, money-lenders, pawn-brokers, commission agents or brokers, an insurance business, the business of carrying on an educational establishment, agricultural undertakings and undertakings for the export of any manufactured or processed articles. The Minister of Finance was also empowered to exempt the turnover of any other business from the business turnover tax.[28] The base of the tax was the actual turnover and "turnover" was defined by the 1963 law to mean the amount of the gross receipts other than receipts from the sale of capital assets. However, in determining the amount of turnover, the gross receipts of an exempted business and the receipts from the sale of "excepted articles" were excluded. The place of business was significant in ascertaining the tax paying unit in that each branch of the business located in a different place was deemed to be a separate business while different businesses carried on by the same person in one place were regarded as one business. Liability to the tax was for every year of assessment in respect of the turnover of that year of assessment.[29]

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26. Ibid., p.52.

27. Person includes a company or a body of persons.

28. Section 120(3)(c)(xi)

29. "Year of assessment" means the period of twelve months commencing on the first day of October in one year and ending on 30th September in the subsequent year.

However, liability to the tax arose only if the turnover of the accounting year preceding the year of assessment was not less than one hundred thousand rupees.[30]

Rates and Exemptions: The rate structure consisted of a ½ per cent general rate and a supplementary 3 per cent rate applicable to manufacturing businesses.[31] The tax law gives the Minister of Finance the power to exempt any article from liability to the business turnover tax.[32] The commodity exemptions included agricultural produce of Sri Lanka, agricultural and industrial machinery, animal foods, arrack sold in taverns, articles manufactured in Sri Lanka and exported, books, bread, cigarettes, magazines and periodicals, newspapers, rice(uncooked), safety matches, sugar, toddy sold in taverns and wheat flour.[33] There were also certain reliefs designed to lessen the tax burden. Provision was made to restrict the business turnover tax chargeable to 80 per cent of the profits or income derived from the business as determined for income tax purposes. Thus, in the case of a business which incurs a loss, there was no liability for business turnover tax. Further, the business turnover tax paid during an accounting year was allowed as a deduction in computing his profits for income tax.

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30. For instance, a person was liable to the business turnover tax for the year of assessment 1967-68(that is in respect of the turnover for the period October1, 1967 to September 30, 1968) if his turnover for the accounting year ending prior to October 1, 1967 (for example, year ending 31st March, 1967, 30th June, 1967, 30th September, 1967) was not less than Rupees 100,000.

31. Minister of Finance fixes the rates of tax by Order published in the Gazette-Section 119(1). Vide Gazette Extraordinary No. 13871 of 27.12.1963. The tax rates proposed in the Budget Speech were 1-10 per cent on manufacturing businesses and ½ per cent on other businesses. During the Committee Stage of the Finance Bill, the tax rate on manufacturers' turnover was reduced to 3 per cent.

32. Section 121(1)

33. Vide Gazette Extraordinary No. 13871 of 27.12.1963.