

# The Impact of Tax Avoidance in the context of Economic Development in Sri Lanka: A Critique of Income Tax and Tax Avoidance

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**Abstract-** *Income tax is a tax on income. The very important financial obligations of the country are bound by the revenue of the country. Tax avoidance and Tax evasion are very similar words which could be more affected to the Tax on Income. Tax avoidance is a crucial situation in the tax system, because Levy of income tax has social effects too, besides its effect on economic life and the development of the community. Mainly it engages public purpose as it is for public and referred to public welfare activities, salaries of public servants and debts.*

*In this context, this paper argues that the existing legal framework applicable to define the concept of income and Tax avoidance. This argument is supported mainly referring to the relevant Sri Lankan legal authorities. Thus the objective of this paper is threefold; first is to explore the scope and objectives of these legal frameworks; the second is to identify their deficiencies and the third is to make appropriate recommendations to improve the existing legal frameworks. The methodology adopted in this research paper entails two research methods: literature review and comparative legal analysis.*

**Key Words** - Income Tax, Tax Avoidance, Economic Development

## I. INTRODUCTION

The tax is a compulsory contribution to the support of government levied on persons, property, income, commodities and transactions. This description tells us very little, beyond the fact that taxes are compulsory. According to this criterion one may add that taxes are imposed under the authority of the legislature levied by a public body and that they are intended for public

purposes. From this income, State could have prevailed severe financial difficulties in the country.

The role of taxes in Sri Lanka has developed dramatically to enable the government to implement its fiscal policy in order to become more independent. The tax system in Sri Lanka was expanded to achieve not only fiscal objectives, but also economic and social objectives. Taxes in Sri Lanka are fiscal instruments used by the government to affect the national economy, encourage investment in sustainable projects, control consumption of commodities and services, and remedy income inequalities among individuals. The Sri Lankan Government has given top priority to reforming the tax system to achieve integration and comprehensiveness in direct and indirect taxes and achieve tax equality.

## II. INCOME TAX

Income Tax Laws, rules and regulations in Sri Lanka come from different sources. The most important source is the Inland Revenue Act No 10 of 2006 (IRA) which provides general principles that guide the government in enacting further tax laws. There are also government decrees, regulations, and instructions that form a source of tax law in Sri Lanka. Among different types of taxes, income tax is the imperative and essential tax from others. It is very difficult to find out a clear definition from the definitions given by the authorities and it does not have a precise definition in words for income. Lord Macnaughten in *London County Council V Attorney General*<sup>1</sup> said "Income tax, if I may be pardoned for saying so, is a tax on Income"<sup>2</sup>. The Inland Revenue Act provides a definition for the term "income". Even so, the term 'income' has been defined in its interpretation section in 217 as

profits or income;<sup>iii</sup> it does not have a precise definition in words for income. This can be manifested in the section 2(1) of the act, where income is coupled with the term 'profits<sup>iv</sup>'. The section 3 of the act is mentioning the classification of profits and income for tax.

Income tax is useful for conducting welfare activities of the government. Mainly, it engages public purpose as it is for public and referred to public welfare activities, balancing of income inequality, salaries of public servants and debts. Imposition of tax directly affects the sum available for spending by the private sector of the economy, and raising or lowering of the general rates of tax even marginally, can have marked deflationary or inflationary effect. The tax may encourage or discourage particular types of activity in the private sector, by treating a particular type of activity more or less favorable for tax purposes compared with other available activities. This is at times deliberately done when the government provides for some special relief, such as investment allowances and economic development purposes. Levy of income tax has social effects too, besides its effect on the economic life of the community. Highly progressive rates of tax on individuals which provide the money for various welfare functions of the state have significant social consequences<sup>v</sup>. Numerous types of tax reliefs given to charities, the provisions of various types of pensions, etc. affect the social structure of the community to a substantial extent, though these factors cannot be evaluated in exact terms.

#### TAX AVOIDANCE AND EVASION

Tax avoidance and Tax evasion are very similar words which could be more affected to the Tax on Income. Tax avoidance is a crucial situation in the tax system, because Levy of income tax has social effects too, besides its effect on economic life and the development of the community. Highly progressive rates of tax on individuals which provide the money for various welfare functions of the state have significant social consequences. Affect the social structure of the community to a substantial extent, though these factors cannot be evaluated in exact terms.

The classic distinction between avoidance and evasion is due to Oliver Wendell Holmes, who wrote,

*'When the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as evasion, what is meant is that it is on the wrong side of the line'<sup>vi</sup>*

Tax avoidance may be considered as either the amoral escaping of one's duties to society, part of a strategy of not supporting violent government activities or just the right of every citizen to find all the legal ways to avoid paying too much tax. Tax evasion, on the other hand, is a crime in almost all countries and subjects the guilty party to fines or even imprisonment<sup>vii</sup>. Some contribute their unpaid taxes to donations and charity, though paying a percentage of tax equal to the budget. In either case, they typically do not take the position that the tax laws are themselves illegal or do not apply to them and they are more concerned with not paying for what they oppose than they are motivated by the desire to keep more of their money.

In the IRA Act, sections 103, 202 and 204 have given the literal meaning of the Tax avoidance and evasion. According to the meanings of these two words the meaning of Tax Avoidance is the legal exploitation of the tax regime to one's own advantage or attempt to reduce taxes through lawful means and Tax evasion means an effort to avoid the payment of Taxes by illegal. In such cases, *Rajaratnam V CIR*<sup>viii</sup>, *Dawoodbhoj V CGIR*<sup>ix</sup> and *Abeyasinghe V Gunawardena, CIR and Others*<sup>x</sup> also interpreted the issues relating to Tax Avoidance and Tax evasion. To create an effective system of taxation and analyse the concept of Income in Taxation, a nation must make choices regarding the distribution of the tax burden, which will pay taxes, how much they will pay and how the taxes collected will be spent. Therefore, it should be better to pay tax and do the duty as taxpayers and citizens of the country.

#### III. TAX AND ECONOMY

In levying taxes, the government must see to it that taxes achieve equality and social justice. The structure of the Sri Lankan income tax is to be progressive in nature. Then in Sri Lanka, the tax rate structure is progressive. They're higher-income individuals pay a greater percentage of their income to the government than do low-

income individuals. Income tax plays a crucial role in Sri Lanka because it furnishes the treasury of its total revenues. The Sri Lankan tax law provides that taxes are compulsory payments, collected for state and public welfare. They are to be collected from natural individuals as well as enterprises.

According to the Sri Lankan Income Tax Law, tax avoidance and evasion involve purposive actions or attempted actions taken by taxpayers with the aim at evading or reducing the payment of tax. Such as tax exemptions and relief, tax holidays, deduction charities, submitting an incorrect statement of accounts, making false entries or alterations, or false books or records, destruction of books or records, concealment of assets or covering up sources of income constitute.

Frequent changes in Income Tax Law have served to complicate the tax regime and that provide possible explanations for income tax avoidance within the current Income tax law. Over the past years, there have been 7 amendments made to the Income Tax Law including substantive amendments. There are many other tax regulations, tax schedules, government instructions, and ministerial orders and rulings. Changes in the Income Tax Law and regulations make it difficult for a taxpayer to get tax return exactly right.

Lack of knowledge also a problem for this situation. The knowledge of the taxpayers of Income Tax Law is not well enough to complete their own tax returns and may not understand all the questions on tax returns. Tax professionals have greater technical knowledge, can maneuver through complex tax law, and maximize tax refunds. However, tax professionals could face a dilemma of balancing ethical tax behavior and client expectations.

#### IV. SUGGESTIONS AND CONCLUSION

The problem of income tax avoidance has become the subject of debates in the society. However, only made the problem worse and led to a breakdown in the relationship between the public and the Income Tax Department. The following suggestions help to reduce the problem of tax avoidance. These methods involve both legal and non-legal techniques.

The Government should adopt stricter procedures for the amendment of Income Tax Law and these procedures will prevent the frequent changes which have needlessly complicated the current income tax regime. The Government should put into place a new tax law with all the amendments up to date. Among the new tax law's features are broad tax base and lower rates, which could create a more stable economic environment.

The other suggestion of undertaking this problem is through punishments. Civil and criminal penalties should be increased and tax evasion should be upgraded from an offense to a crime. However, adoption of stringent penalties may have adverse effects by increasing tax non-compliance. Therefore, the government should strike the right balance regarding the correct type and size of remedies.

The government should create tax compliance culture through education by creating for example, pamphlets to familiarize school students with the notion of taxation and instill compliance. Moreover, the government can use newspapers, TV advertisements, and public meetings with taxpayers. The purpose of these activities is to develop among the general public a better understanding of the role of the income tax system and of the relationship between proper taxpaying and good citizenship.

Computerization plays an important role in the effort to improve service and there should be continuous training for tax officers on how to provide rapid and courteous service.

The Income Tax Department should adopt scientific procedures in collecting data and selecting taxpayers for further audit. This type of inspecting could generate positive impression on the compliance approaches and practices of taxpayers' in general. The Income Tax Department could set up a fraud hotline to report people who seemed to evade their tax obligations. Through letters and phones tax assessors should communicate more with taxpayers and this type of communication could help minimize the habit of taxpayers who just drop in the tax offices without appointment.

The negative perception of the government among public is not can be easily changed. However,

provisions against favoritism, improving enforcement, and further public participation in the tax assessment process would help restore taxpayers' faith in their government. This would help for the betterment of the country economy as well as public welfares.

Administrative complications as well as widespread avoidance and evasion are caused by the failure of legislators to agree upon a well-defined law. The administration of tax systems with the public welfares may lead to a more complete understanding of the reality of taxation. Tax avoidance and evasion are pervasive in all countries, and tax structures are undoubtedly skewed by this reality. Standard models of taxation and their conclusions must reflect these realities.

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<sup>1</sup> 1901 AC 26

<sup>2</sup> "If an item of money is not income within the meaning of the act, it is not subject under the IRA." Also "income tax is a tax on income and not a tax on anything else."

<sup>3</sup> 'Profits' or 'income' means the net profit or income from any source for any period calculated in accordance with the provisions of this Act."

<sup>4</sup> 'Income Tax... in respect of the profits and income of every person for that year of assessment..'

<sup>5</sup> The concept of 'Income' is often a reflection of its communal values and the values of those in power. To create an effective system of taxation and analyze the concept of Income in Taxation, a nation must make choices regarding the distribution of the tax burden, which will pay taxes, how much they will pay and how the taxes collected will be spent. In democratic nations, where the public elects those in charge of establishing the tax system, these choices reflect the type of community that the public wishes to create. In countries where the public does not have a significant amount of influence over the system of taxation and to the concept of Income, that system may be more of a reflection on the values of those in power.

<sup>6</sup> *Bullen v. Wisconsin (1916), 240. US. 625 at p. 630/.*

<sup>7</sup> Switzerland is one notable exception: tax fraud (forging documents, for example) is considered a crime, tax evasion (like under declaring assets) is not.

<sup>8</sup> 1969- 73 NLR 128

<sup>9</sup> 1978- 79 SLR 1

<sup>10</sup> 4SLTC 1996 2SLR 336

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