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8.0
PERCENT
Average total taxes paid on gross income by the banking sector (2018-2022)

13.7
PERCENT
Average total taxes paid on gross income by the EPF (2018-2022)

14
PERCENT
Excess tax rate on EPF/ETF returns for those earning below LKR 100,000 monthly

Image courtesy of Unsplash

Retirement Funds Face Regressive Taxation in Sri Lanka

In September 2023, Sri Lanka became the only country to restructure local currency debt by exclusively targeting retirement savings funds, excluding all others. This was justified by claiming that retirement savings were receiving preferential tax treatment. This insight finds both empirical and analytical evidence to the contrary, and shows that retirement funds face adverse, not preferential tax treatment.

Sri Lankan law makes it mandatory for formal private sector employees to effectively contribute 20% of their overall income to Retirement Savings Funds (RSFs). These are restricted long term funds, which can be withdrawn upon reaching the stipulated retirement age or upon permanently exiting the labour force. The overwhelming majority — over 95% — of such contributions are collected by the government managed Employees' Provident Fund (EPF) and Employees' Trust Fund (ETF).

These RSFs are also sometimes referred to as Superannuation Funds. About 13% of the total mandatory contribution is due to the ETF, and the balance to an approved provident fund – with the EPF being the predominant provident fund.

At the end of 2022, the RSFs collectively had LKR 3.95 trillion invested in government securities. The EPF and the ETF held 85% and 11% of these investments, respectively. The Parliament of Sri Lanka on 7 September 2023 passed an amendment to the Inland Revenue Act. This amendment proposed to increase the tax on the returns earned from government securities held by RSFs in Sri Lanka from the existing 14% to 30%. However, the new law allowed RSFs to be exempted from this increase if they "voluntarily" accepted an offer made by the government to exchange much of their existing holdings of a designated set of government securities, for another set of securities with a lower yield.[1]

This was described by some as a "gun to the head"[2] proposition to the RSFs, to accept an adverse restructuring of their portfolio of government bonds. However, government officials presented this as a transition to "equal tax treatment". They argued that RSFs enjoy a highly favourable tax treatment, and that this proposal was simply to withdraw that benefit and establish the same tax treatment that is in place for the rest of the market, if the alternative offer to restructure the portfolio of government bonds was not accepted.

This insight evaluates the "equal tax treatment" claim. The analysis, focusing on the EPF, supports the exact opposite of that claim — that even the existing tax treatment, before the proposed increase, was not preferential but rather adverse on RSFs. The adversity of tax treatment is found to exist in two ways: one, in terms of the taxation of RSFs in relation to financial institutions and two, in terms of the tax treatment of most individuals with savings in RSFs. The only category of savers to whom this tax treatment could seem preferential, and not adverse, are a subset of those who are among the top 20% of income earners in Sri Lanka.

The summary of the findings are as follows:

RSFs pay a much larger share of gross earnings in taxes (twofold or threefold more) than financial institutions. This is because RSFs are effectively taxed on most of their gross income, whereas financial institutions are taxed mainly on net income, even though at a higher tax rate.

The overall tax treatment on EPF contributors earning under LKR 183,333 a month is adverse, not preferential. It becomes more adverse as the income becomes lower. The tax treatment is potentially beneficial only for those earning over LKR 183,333 a month, which would be a subset of those among the top 20% of income earners in the country.

The savings returns of those earning less than LKR 100,000 a month are taxed at almost 14% in the EPF, when it would have been exempt from tax if saved privately.

Brief Background on RSFs in Sri Lanka

The EPF, established in 1958[3], and the ETF, established in 1980, were originally mandatory, tax-free, savings instruments[4] — no tax on the savings, returns to investment of the savings and on the withdrawal of the funds upon retirement.[5]

Salaried employees in formal private sector institutions, and a small segment of government and semi-government institutions, are expected to contribute to the EPF. Some institutions have been given permission to substitute their EPF contribution with contributions to a separate but equivalent provident fund.[6]

In 1989, the government introduced a 10%[7] tax on investment returns of RSFs and in 2018, increased that to 14%.[8] These policy actions, even in the past, were a significant departure from the economic principles of RSF taxation. Both established theory and practice argue for providing significant tax incentives, especially to those at lower income levels, to encourage long-term retirement savings by offsetting the lack of short-term liquidity and flexibility of investment methods. [9]

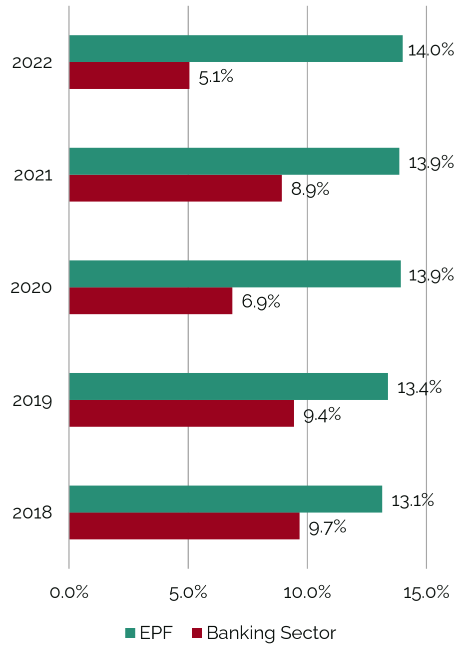
Adverse Tax Treatment of RSFs in Relation to Financial Institutions

Empirical evidence against ETT argument

The "equal tax treatment" (ETT) argument has been made as follows. To quote: "Currently, banks pay over 50% of their income as taxes, including 30% as company tax, 18% as VAT and financial services tax, and 2.5% as social security contribution. Therefore, more than 50% of the banks' earnings are already allocated to taxes and contribute to the government's revenue. In comparison, superannuation funds have a lower tax rate of 14%."[10]

The Central Bank of Sri Lanka (CBSL) publishes information on the overall income and taxes in the banking sector quarterly. It shows the sector being subject to three main taxes: Value Added Tax (VAT) on financial services, Social Security Contribution Levy (SSCL), and Corporate Income Tax, in the rates detailed above. The EPF is only liable for the last of the three categories, that is Income Tax of 14%. This seems to be the basis for the claim.

Exhibit 1: Total tax paid as a percentage of gross income in the banking sector and by the EPF[11]



However, this apparent lower level of tax on the EPF is contradicted by the data on taxes paid. Exhibit 1 illustrates a comparison of the actual taxes paid as a percentage of gross income by both the banking sector and the EPF. According to CBSL data, in the five years from 2018 to 2022, the EPF paid, on average, 13.7% of its gross income in taxes. By contrast, the banking sector paid, on average, only 8.0% of its gross income in VAT, SSCL and Corporate income tax combined in this period.

This data provides prima facie empirical evidence against the argument that the EPF is taxed at a lower rate than the banks, as claimed. The next section analytically explains how the EPF is taxed at a higher rate than other financial institutions, despite the appearance of facing a lower rate of tax.

Analytical evidence against ETT argument

The reason empirical evidence contradicts the ETT argument is because there is a critical difference in

Exhibit 2: Comparison of Taxes paid by Financial Institutions vs EPF

		Calculation	Banks	EPF
X	Funds from Account Holders		1,000,000	1,000,000
A	Gross Income from Investment (10%)		100,000	100,000
B	Returns Credited to Account Holders		85,000	85,000
C	Operating Expenditure for that Investment		1,163	1,163
D	Taxable Income Calculation as it is applied to Financial Institutions (Net Income)	(A-B-C)	13,837	13,837
E	Taxable Income Calculation as it is applied to the EPF	(A-C)	98,837	98,837
F	Superficial Tax Rate on Institutions		30%	14%
G	Actual Taxes Charged from Financial Institutions	Banks: F * D EPF: F * E	4,151	13,837
H	Effective Tax Rate on Gross Investment Income	G/A	4.2%	13.8%
Z	Effective Tax Rate on Net Income	G/D	30%	100%

the way the tax treatment is calculated on RSFs and on other financial institutions. The following analytical explanation is not novel. A version of it was first set out in an article published by a past deputy governor of CBSL.[12]

The critical difference in the tax treatment is this: in assessing taxable income, financial institutions are allowed to deduct from their earnings the interest (returns) credited to the holders of savings accounts or other instruments such as fixed deposits. In contrast, RSFs are not allowed to deduct the returns paid to individual member accounts in assessing their taxable income. This difference results in a much more adverse taxation of RSFs compared to financial institutions, for the same activity of investing and providing returns on the funds deposited by individuals.

Exhibit 2 presents a synthetic example where both banks and the EPF have the same level of investment from members, of LKR 1 million, and generate the same return of LKR 100,000 per year. This exhibit illustrates the significant variation in taxable income and, consequently, the effective tax burden on the EPF and banks. It illustrates how the tax rate on gross income becomes much higher for the EPF than for banks — despite the lower superficial rate on the tin.

In the synthetic example, which tracks actual outcomes, the EPF would be paying 13.8% (just under the tax rate of 14%) as tax on its gross income relative to the 4.2% of gross income paid as tax by financial institutions. The tax rate on net income is 30% for financial institutions, but 100% for the EPF in this scenario. This is by design of the taxation method, which taxes most of the **gross income** of the EPF. As the EPF is a not-for-profit entity, it has nothing left after paying taxes. This means the entire **net income** — when understood as the portion of investment income that is not paid to account holders or spent in operating costs — is exactly what is paid out as tax on the gross income.

Adverse Tax Treatment of Most Individuals Contributing to RSFs

If the government took the policy decision that it does not intend to incentivise long term savings but subject all savings, even enforced retirement savings, to the same tax treatment, there is an additional aspect to be evaluated with regard to the ETT claim. This is due to the difference in how the account holders of the EPF and account holders in financial institutions are taxed **individually,** after receiving the benefits that accrue to their accounts in the respective institutions.

An EPF account holder does not face any further tax on the income received into their account.[13] However, the income received by a bank account holder is taxable, according to their personal income tax schedule — at current rates, as increased in January 2023, the marginal tax rate could range from 0% to 36%.

The return on savings in the EPF, and the taxes collected by government, would be exactly the same, if instead of a 14% tax on the gross returns of the EPF, the government taxed at 14% the full amount that is credited to each individual's EPF account. That is, a person who already pays at least 14% in marginal tax on their investment returns is **no worse off** in terms of tax treatment, if they earn those returns in their EPF account rather than in an alternate financial institution. It is the opposite for those whose income level places them at a marginal tax rate that is lower than 14%. They are always **worse off** in terms of tax treatment, by earning those returns in their EPF account rather than in an alternate financial institution. The marginal tax rate is above 14% only when the monthly income exceeds LKR 183,333 (see Exhibit 3).

Exhibit 3: Marginal tax rates faced by individuals, based on monthly income bracket

Monthly Income (LKR)	Tax Rate (%)
Up to 100,000	0%
100,001 - 141,667	6%
141,668 - 183,333	12%
183,334 - 225,000	18%
225,001 - 266,667	24%
266,668 - 308,333	30%
Above 308,334	36%

Therefore, to reiterate — individuals with average monthly earnings of less than LKR 183,333 would be worse off, paying more in taxes for their savings returns in the EPF than if they were allowed to deposit those savings privately in other financial institutions, where the current applicable tax rate would be between 0%-12%.

A tax methodology that is beneficial to those with higher incomes and adverse to those with lower incomes is considered regressive. In the case of how the EPF is taxed, it is adverse towards those with incomes lower than LKR 183,333 a month, and becomes more adverse as the income reduces. For instance, an individual with a monthly income from all sources below LKR 100,000 would be exempt from taxation on the interest income on their savings. Despite this, the individual is forced to have 20% of their overall income deposited in RSFs, the returns on which they are taxed at 14%. The same individual would be liable to zero taxes on those returns, if they were allowed the freedom to invest those savings independently of the RSFs. ◆

Endnotes

1 Department of Printing, "Inland Revenue (Amendment) Bill 2023", available at: http://www.documents.gov.lk/files/bill/2023/8/371-2023_E.pdf [last accessed 12th September 2023]

2 Volume 304 - No. 9, 01st July, 2023, 'Manthri.lk', p. 29, Available at: https://assets.manthri.lk/uploads/hansard/manthri.lk.hansard.304-9-2023-07-01.pdf [last accessed: 12th September 2023]

3 Employees' Provident Fund Act No 15 of 1985, Section 43, Sub-Section 1, available at: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/acts/en/epf_act.pdf [last accessed 12th September 2023]

4 A 10% income tax on the EPF and the ETF was introduced with the Inland Revenue (Amendment) Act (No. 11 of 1989), Third Schedule, p. 296, available at: http://www.ird.gov.lk/en/publications/Income%20Tax_Documents/IR_Act_No_10[E]_2006_(Consolidation_2015).pdf, [last accessed 12th September 2023]

5 However about 35% of the effective income earned by workers, and deposited as enforced savings in these funds, was subject to the marginal rate of income tax faced by the income earner -- this is because the employees contribution part of 8% is taxed, while the employers contribution part of 15% is not taxed.

6 Employees' Provident Fund Act No 15 of 1985, Section 27, Sub-section 1 and 2, available at: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/acts/en/epf_act.pdf [last accessed 12th September 2023]

7 A 10% income tax on the EPF and the ETF was introduced with the Inland Revenue (Amendment) Act (No. 11 of 1989), Third Schedule, p. 296, available at: http://www.ird.gov.lk/en/publications/Income%20Tax_Documents/IR_Act_No_10[E]_2006_(Consolidation_2015).pdf, [last accessed 12th September 2023]

8 INLAND REVENUE ACT, No. 24 OF 2017, First Schedule, p.205, available at: http://www.ird.gov.lk/en/publications/Acts_Income%20Tax_2017/IR_Act_No._24_2017_E.pdf [last accessed 12th September 2023]

9 See for example: Whitehouse, E. (2016) 'The tax treatment of funded pensions', OECD. Available at: https://www.oecd.org/finance/private-pensions/2391559.pdf [last accessed 12th September 2023]. To quote: "In most countries, income accruing in the pension fund accumulates tax-free.... Denmark taxes only real investment returns"

10 Presidential Secretariat Press Release, "CB Governor gives firm assurance that the safety of 57 million bank deposits will be upheld" available at: https://www.presidentsoffice.gov.lk/index.php/2023/06/29/cb-governor-gives-firm-assurance-that-the-safety-of-57-million-bank-deposits-will-be-upheld/ [last accessed 12th September 2023]

11 Source: Central Bank Financial Sector Profitability data | EPF Annual Reports
Note: Taxes for the banking sector includes Corporate income tax, VAT and SSCL while taxes for EPF includes only corporate income tax as VAT and other taxes do not apply to the EPF

12 W.A Wijewardena, 10 July 2023, "The misunderstood taxation of EPF and other superannuation funds" available at: https://www.ft.lk/columns/The-misunderstood-taxation-of-EPF-and-other-superannuation-funds/4-750423 [last accessed 12th September 2023]

13 The ETF seems to face a further tax of 10% of the entire balances, when funds are withdrawn at retirement, which would make its tax treatment more adverse than other RSFs that don't face such an exit tax.