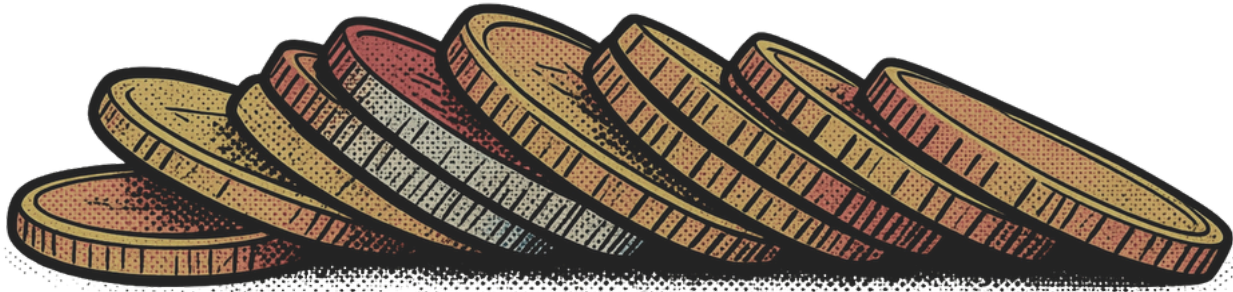


SHOULD SRI LANKA RE-INTRODUCE A TAX OMBUDSMAN?



Tax Ombudsmen exist in many countries. They are independent officials (or offices) whose role is to help taxpayers resolve disputes with tax authorities – fairly, quickly and without cost. In essence, they are intended to protect taxpayers from unfair treatment at the hands of tax authorities. The basis of the case for Tax Ombudsmen is the understanding that, in many countries, the balance of negotiating power between taxpayers and tax authorities is weighted too much in favour of the latter.

Tax authorities may have:

- i) the power to make tax assessments that they know are excessive
- ii) discretion to demand extensive documentation from taxpayers, sometimes long after the tax year to which a case relates
- iii) the backing of appeals procedures that are not genuinely independent and highly likely to support the tax authority
- iv) the ability to require taxpayers who question assessments to make substantial cash deposits depending on the final resolution of disputes, that may be long delayed
- v) the authority to delay the production of tax assessments until minor failures to reconcile accounts derived from paper-based sources are fully resolved
- vi) or the freedom not to publish expeditiously the judgements that have emerged from previous disputed tax cases

That power imbalance is exacerbated if taxpayers

- i) cannot rely on the tax authority website to provide reliable information and guidance and/or
- ii) find it difficult to obtain specific guidance from tax authority staff through telephone helplines, emails or in-person meetings.

These problems all occur in the relationships between the Inland Revenue Department (IRD) and Sri Lankan taxpayers. By international standards, they are not chronic. They are nevertheless problematic in several senses. Too many taxpayer and IRD resources are tied up in discussion and negotiation around cases that could be settled more quickly and cheaply. IRD assessment decisions are less predictable than they should be, with consequent adverse effects on business planning. More important, the reputation of the IRD among taxpayers is generally very poor. That undermines willingness to pay tax. Taxpayers generally try to avoid interacting with the IRD.

Professional tax advisers generally advise their clients to avoid any formal appeal against IRD assessments, on the grounds that the likely costs, in time, money and uncertainty, outweigh the costs of agreeing to excessive assessments.

The case for having a Tax Ombudsman in Sri Lanka sounds strong. But there was actually a Tax Ombudsman in Sri Lanka between 2005 and 2007. It did not work well, and the role fell into abeyance.¹ It is not easy to establish a Tax Ombudsman system that works well.

WHAT DOES A TAX OMBUDSMAN DO?

Taxing inevitably generates some friction between taxpayers and tax authorities. One of the roles of Tax Ombudsmen is to encourage changes in procedure that reduce friction in the longer term, so that taxpayers are less likely to feel aggrieved while tax authorities retain the powers that they need to do their job effectively.

More concretely, a Tax Ombudsman will typically:

- Investigate complaints from taxpayers that they have been treated unreasonably or unfairly by the tax authority.
- Either recommend remedies, if the office has only advisory power or, if it has legal authority, issue directives to the tax authority.²
- Generally mediate between taxpayers and tax authorities and, possibly, suggest or require changes in tax authority procedures to reduce the incidence of future disputes.

The issues that are referred to the Tax Ombudsman are typically: administrative errors; unreasonable conduct by tax officers; poor communication or lack of response from tax officials; delays in the issue of tax refunds; or procedural unfairness.

The issue that is of central importance to taxpayers most of the time is not in this list: actual tax assessments, i.e. judgements about what tax needs to be paid. It is the actual assessments that lie at the heart of most disputes between taxpayers and tax authorities. Taxpayers are often willing to turn a blind eye to what they might see as procedural errors if they finally receive a tax bill they find acceptable. Tax Ombudsmen can rule on all the procedural and behavioural issues affecting a tax assessment, but they cannot challenge the assessment itself. Were they empowered to do that, they would in effect become a competing tax authority, and would need access to some of the legal and accounting skills and resources that go into determining tax assessments.

There are several reasons why Tax Ombudsmen often disappoint. The two most significant are:

- There is a mismatch between high expectations on the part of taxpayers and the reality that the authority of the Tax Ombudsman is limited to procedural rather than substantive assessment issues.
- The assessment procedures used by tax authorities are typically quite complex and in varying degrees stem from the complexities of tax law. It is generally agreed that, to guarantee impartiality, Tax Ombudsmen should not be former staff of the tax authority. But, once former staff are excluded, it is often hard to find other professionals – typically lawyers or judges – who have an adequate understanding of tax and the law to do the job effectively. Tax Ombudsmen are typically senior people near retirement age who are unlikely to serve many years in the post, and therefore have limited opportunity to develop expertise.

¹The first Tax Ombudsman was appointed in 2005 for a two year term. No further appointment was made when that term expired.

²If the tax authority ignores those rulings, the Tax Ombudsman might in principle need to go to law to have them enforced.

DOES SRI LANKA NEED A TAX OMBUDSMAN?

That is actually not the best question to ask. The better question is:

What are the most cost-effective means of shifting the balance of power between taxpayers and the IRD more in favour of the taxpayer?

There is a wide range of possible answers to that question. We already mentioned some above, including more reliable and informative tax authority websites and greater access to useful advice from tax authority staff. IRD operations and interactions with taxpayers are currently only partly digitised. They are still to some extent paper-based, and this intrinsically generates errors, work, and the potential for misunderstanding. For example, it takes longer to reconcile paper-based accounts, and errors are more likely to creep in. The IRD questions some paper-based tax returns on the grounds that the accounting information contained on different pieces of paper does not fully reconcile – even if the differences are trivial in cash terms. In such cases, taxpayers may still be required to provide further documentation and expend time and effort in trying to fully reconcile different sources. Were the processes of filing and assessing tax returns fully digitalised, there would be fewer reconciliation problems and they could be more easily resolved by introducing automated rules to ignore minor accounting discrepancies. The broader point is that the digitalisation of tax administration and many other ‘standard’ tax administration reforms will tend to shift some bargaining power from the IRD to the taxpayer. We focus here on the potential for direct legal and procedural changes in the ways in which disputes and appeals are handled by the IRD. The re-creation of a Tax Ombudsman office is one of a suite of ways improving the handling of disputes and appeals issues. Broadly, there are three main potential strategies that might be pursued.

1. A tax administration law?

The most thorough and radical approach to this issue would be to introduce a tax administration law. Separate from laws about what taxes are to be paid, a tax administration law would specify the procedures to be followed by the tax administration for the entire tax process – registration, returns filing, assessments, audits, appeals, enforcement, arrears, penalties and interest etc. Tax administration law is a sub-set of administrative law. Taxes are generally collected under tax administration laws in countries where administrative law is well developed. In essence, public (and tax) agencies can be made answerable in court for failures to follow legally-specified administrative procedures. The notion of a tax administration law has occasionally found favour in Sri Lanka, in response to the perception that tax authorities have far too much discretion in the ways in which they choose to interact with taxpayers.

However, it would not make sense to try to solve the problem of imbalances of power between taxpayer and tax authority by introducing a tax administration law. There are two reasons for that. First, while the Sri Lankan legal system is a hybrid, the English common law tradition is dominant in respect of public law and procedure, commercial and mercantile law and judicial method (reasoning and precedent).

A tax administration law would be an anomaly – a more ‘Dutch-Roman’ legal implant into an area of law that is dominantly influenced by English common law. The costs involved in departing so radically from current mainstream legal institutions are likely enormous.

The second reason to reject the tax administration law option is more concrete: there is no strong evidence that the outcome would be better than the current (common law) system. The notion that tax administrations would be required to adhere to clearly specified procedures while taxing is attractive. But taxation processes tend to be very complex, not least because they differ for each of a wide range of taxes. So tax administration law manuals tend to be very long. Further, because taxes change over time and new collection technologies are continually emerging, tax administration laws run the risk of either (a) ossifying into law outdated practices or (b) needing continual legal amendment to take account of technological or other changes. The promises of clarity and certainty embodied in the basic case for tax administration laws are often unmet.

2. Marginal improvements to the current system?

There are problems of power imbalances between Sri Lankan taxpayers and the IRD, but they are not chronic. Some elements of the current system work well. A good example is the Tax Appeals Commission (TAC). This is an independent tribunal that deals with assessment cases that cannot be resolved administratively (i.e. through administrative reviews organised by the Commissioner-General of Inland Revenue). Both the Commissioner-General and taxpayers have the right to take cases to the TAC, but only after they have been through an administrative review process within the IRD. We reviewed all 162 cases on which the TAC reached a decision between 2013, when the Commission became operational, and March 2025. The IRD was the appellant in 132 cases and firms in 30 cases (19%). Overall, the IRD lost 77 cases, 48% of the total, including 26 of the 30 cases brought by firms. These figures are consistent with the view that the TAC system functions relatively effectively as a constraint on the IRD – even if the time taken to resolve cases tends to be long, and it is really only large firms that can afford to appeal.³

The prior stage to the appeals process – administrative review within the IRD – functions much less satisfactorily. Note that the taxpayer has to go through this stage before they are able appeal to the Tax Appeals Commission. But the administrative review process in practice offers the taxpayer a chance of success that is close to zero.⁴ Virtually all appeals are rejected. Even if they are accepted in the early stages of the administrative review process, when an IRD staffer is appointed to review assessments made by a fellow officer, they are rejected when the final determination is made at the level of the Commissioner-General of the IRD. Related, the IRD reports almost nothing about the administrative review process. It does NOT report any of the following information: the number of administrative reviews requested; the types of taxes or cases to which they relate; the time taken to undertake the administrative reviews; or the outcomes.⁵ Neither does the IRD give guidance to potential future appellants by publish explanations of why they reject particular cases. A company that is unsure whether a particular interpretation of a complex legal point will be accepted by the IRD is unable to consult the record to see whether other companies that have attempted to follow the same route have been successful or not. They have no option but to use up their own resources – and those of the IRD – by requesting an internal review.⁶

³ Taxpayers appealing to the Tax Appeals Commission are required to make an upfront deposit of 25% of the disputed amount of tax, the potential penalty and interest.

⁴ One very experienced tax adviser who regarded the Tax Appeals Commission as broadly fair and effective and had won cases there reported having only once been successful in the administrative review process.

⁵ Some of this statistical information has been included in the IRD's Annual Performance Report at some points in the past.

⁶ There still exist stereotypes about Sri Lankans being exceptionally litigious, i.e. eager to go to law to settle disputes. We heard variants of these stereotypes from both sides in our discussions of the tax appeals process: IRD staff suggesting that "our people will always appeal" and tax advisers claiming that "the IRD will always appeal if it loses a case". To the extent that we can find internationally comparative statistics on the incidence of (a) internal reviews within IRD and (b) appeals to the Tax Appeals Commission, it seems that the rates in Sri Lanka are not high by international standards, and may indeed be relatively low.

The fact that the internal review process is so secretive and so heavily weighted in favour of the IRD is probably the most graphic evidence for the broader claim that the balance of bargaining power in the taxation process is excessively weighted in favour of the IRD. It should be possible to begin to deal with this issue by remedying the problems listed above, before even re-introducing the Tax Ombudsman. In particular:

- The IRD's internal review process needs amending such that it ceases to look like a purely formal technique for rejecting virtually all appeals. This could be as simple as requiring the IRD to expeditiously publish the outcomes of every internal appeal, with statements of the arguments on both sides and the reasons for the final decision. If followed correctly, this procedure should deal with the problem that the valuable information from IRD rulings on internal appeals is not available to other taxpayers.
- The IRD should be asked to monitor and report on its own performance in dealing with internal reviews by publishing, in each Annual Performance Report, detailed information on the stocks and flows of cases (number new, number settled, median time to settlement etc), along with some thematic information on the issues being appealed (by tax type and more specific issues).

3. A new Tax Ombudsman?

The Sri Lankan tax system would probably be significantly improved with an effective Tax Ombudsman. But introducing one is not an immediate priority, for three main reasons:

- There are currently much more urgent issues around tax administration that need to be resolved. Scarce expertise and energy should be directed there first.
- Ombudsman legislation would need to be carefully prepared, in the light of international experience. This is not a task to be rushed.
- As suggested above, there are other steps that could be taken to improve the ways in which the IRD deals with disputes and appeals that are likely to be much more cost-effective, and will also help internalise a more transparent approach to these issues within the organisation.

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