

KB 3 – Business Taxation & Law

Suggested Answers and Marking Guide

Section 1 - Business Law

Question 01

Restrictions in selecting a name

Relevant learning outcomes
2.2.2 Explain the process and restrictions in selecting a name.

Pre-incorporation contracts

Relevant learning outcomes
2.3.1 Analyze the rights and duties of promoters, including liability for pre-incorporation contracts, with relevant cases.

With respect to the single shareholder issue, the legal situation is as follows:

Single shareholder companies are allowed under Section 4(2) of the Companies Act, No. 7 of 2007, which says that an individual can be the single shareholder of a company.

(1/2 mark)

Therefore it is legally valid for Arvis to function as the sole shareholder of the proposed company.

(1/2 mark)

With respect to the two names proposed by Arvis, the legal situation is as follows:

Since the company is a private limited liability company, both the proposed names should end with the words "(Private) Limited".

(1 mark)

Before selecting either of the two names, Arvis will have to check the names register at the Registrar of Companies to ascertain whether an already existing company carries the same names as the proposed names. [Ref: Section 7(1)].

(1/2 mark)

If the answer is "yes", then Arvis cannot use that particular name/s for his company.

(1/2 mark)

If the answer is “no”, then the situation is as follows:

- “Arvis Movies (Private) Limited” can be used and Arvis is likely to get approval for this name.

(1/2 mark)

- “Ceylon Circus (Private) Limited” -

This name can only be used by Arvis if, and only if, the Minister in charge of the subject gives the approval to use the word “Ceylon” in the company’s name.

(1 mark)

The reason being that the word “Ceylon” signifies a connection to the Government of Sri Lanka, and in such a case it becomes necessary to obtain the permission of the Minister. [Ref: Section 7(2)]. .

(1/2 mark)

Therefore if the above criterion is fulfilled, Arvis may get approval to use the proposed name “Ceylon Circus (Private) Limited”.

With respect to the contract entered into by Arvis and Xinta, the legal situation is as follows:

If Arvis had indicated the following to Xinta at the time of entering into the contract, then the contract can be treated as a “pre-incorporation contract” under the Companies Act. **(1 mark):**

- That Arvis is entering into the contract on behalf of the company proposed to be incorporated **(1/2 mark)** and in contemplation of its incorporation. **(1/2 mark)**
- That once the proposed company is incorporated **(1/2 mark)**, the contract will be ratified **(1/2 mark)** within such period as may be specified in the contract **(1/2 mark)** or if no such period is specified, within a reasonable time after the incorporation of the proposed company. **(1/2 mark)**

Therefore a pre-incorporation contract of this nature, once ratified, shall be as valid and enforceable as if the company had been a party to the contract at the time it was entered into.

(1 mark)

Total for Question 01 = 10 marks

Question 02

Dividends

Relevant learning outcomes
3.2.1 Explain the procedure for payment of dividends including that of a listed company.

As the Company's Articles of Association are in accordance with the Model Articles **(1 mark)**, and as a dividend declaration falls within the definition of a "distribution" under the Act **(1 mark)**, Section 56 applies to this particular dividend distribution. **(1 mark)**

Section 56 says that the proposed dividend should first be authorized by a board resolution **(1 mark)** and thereafter by an ordinary resolution of the shareholders. **(1 mark)**

However, the board of directors will have to ensure that the Company will pass a solvency test after this dividend is declared **(1 mark)**, and in this context they should obtain a Certificate of Solvency from the Company's auditors. **(1 mark)**

Further, all directors who have voted in favour of the dividend distribution must sign a certificate to that extent. **(1 mark)**

In the event that the procedure set out in Section 56 of the Act has not been followed every director who either:

- Failed to take reasonable steps to ensure the procedure was followed; **(1/2 mark)** or
- Signed the certificate; **(1/2 mark)**

will be personally liable to the Company to repay to the Company, so much of the distribution as the Company is not able to recover from shareholders [Ref : Section 61(2)].

(1 mark)

Total for Question 02 = 10 marks

Question 03

(a) Directors' duties

Relevant learning outcomes
2.5.2 Explain the method of contracting and authority of directors, officers and agents.

In the given scenario, the feasibility report is prepared by a team of professionals who are also employees of the Company.

This is in line with Section 190(1), which allows the board of directors to rely on reports prepared and submitted to the board by employees of the company **(1 mark)** who are also experts and professionals in their field of work. **(1 mark)**

Further, as per the facts of the given scenario, there is nothing to indicate that the directors have acted contrary **(1/2 mark)** to the conditions imposed by Section 190(2). These conditions are as follows:

- The board must act in good faith. **(1/2 mark)**
- The board must make inquiries, if the circumstances warrant such inquiry. **(1/2 mark)**
- The board has no knowledge that such reliance is unwarranted. **(1/2 mark)**

Therefore, as per the facts discussed above and from the facts given in the scenario, it seems that the board of directors can rely **(1 mark)** on this feasibility report in making its decision on whether to go ahead with the mini hydro project or not.

(Total 5 marks)

(b) Resolution to re-appoint the auditor

Relevant Learning Outcomes
5.2.2 Prepare resolutions for re-appointment of directors, re-appointment of auditors, and declaration of dividends.

The resolution required under the Companies Act, to re-appoint Essell as the auditor of the Company, is an ordinary resolution of the shareholders of the Company, the draft of which is as follows:

Compliance (Pvt) Ltd.
Ordinary Resolution (1 mark)

IT IS HEREBY RESOLVED **(1/2 mark)** by the shareholders **(1 mark)** of Compliance (Pvt) Ltd. **(1/2 mark)**, to re-appoint **(1/2 mark)** Essell, Chartered Accountants **(1/2 mark)**, as the auditor of the Company for the financial year 2015/2016. **(1/2 mark)**

IT IS HEREBY FURTHER RESOLVED by the shareholders, to fix the remuneration of Essell at Rs. 100,000/- plus taxes plus direct re-imbursable expenses." **(1/2 mark)**

(Total 5 marks)

Total for Question 03 = 10 marks

Question 04

(a) Features of a limited liability company:

Relevant learning outcomes
1.2.1 Define the term “company”.
1.1.2 Explain the general features of a company registered under the Companies Act., including the new features.

The following are the general features of a private limited liability company.

1. Separate legal entity

A company is not just an association of persons but is a separate legal entity. It is an artificial person in the eyes of the law. It is distinctly separate from its owners, and as a result it can even contract with its members. This “separate legal entity” feature was first laid down in the famous decided case of Salomon vs. Salomon and Company Ltd.

2. Separate property

Another feature is that a company owns property separately from its owners. It can purchase or sell its property without the permission of its shareholders or owners. In other words, the assets of a company are not the assets of its owners, as in partnerships.

3. Limited liability

Limited liability is another important feature of a company. This is one main reason that a large number of investors invest in limited liability companies. It is the liability of the company to repay its creditors, and this repayment is not the liability of its owners. The owners’ liability is limited up to the purchased value of shares in the company. The owners are only liable to pay any balance amount of moneys due to the company, on the shares purchased by them.

4. Perpetual succession

The life of a company is more stable than that of a human being. Its existence is not affected by its owners’ existence. Shares can easily be transferred from one member to another member. Therefore, liquidation of the company is only possible through the provisions laid down by the law.

5. Right to sue

A company can sue in its name any other party, just like a natural person, in order to protect its assets and properties. Other persons too can sue the company in its name.

(1 mark per point up to a total of 5 marks)

(b) Functions of the administrator

Relevant learning outcomes
6.2.1 Functions of administrators / liquidator and receiver/managers

Section 412(1)(b) of the Companies Act prohibits a creditor of a company from acting as its administrator. **(1/2 mark)**

Therefore, Zee (Pvt) Ltd, cannot appoint Bee as its Administrator. **(1/2 mark)**

However, in the case of Dee the situation is different. Since he is a neutral person and is not disqualified (as per the given information in the scenario), to act as an administrator under the Companies Act **(1/2 mark)**, Zee (Pvt) Ltd can consider appointing Dee as its administrator, subject to the facts given below. **(1/2 mark)**

In considering the scenario where the Company proposes to appoint an administrator to strike a compromise with its creditors, the following should be noted.

The Companies Act in Section 401 **(1/2 mark)** permits the board of directors of a company to appoint an administrator by passing a board resolution, for the purpose of striking a compromise with its creditors under Parts IX and X of the Companies Act.

As per the facts of the given scenario, since the purpose of appointing an administrator is to strike up a compromise with the creditors under the provisions of the Companies Act **(1/2 mark)**, the directors can appoint Dee as the administrator of the Company by passing a board resolution to that effect. **(1/2 mark)**

This resolution should specifically mention the purpose for which the administrator is appointed. **(1/2 mark)**

However, prior to the appointment, the directors of the Company, should obtain Dee's written consent to act as the administrator of the Company. **(1 mark)**

(5 marks)

Total for Question 04 = 10 marks

Question 05

(a)

Relevant learning outcomes
7.1.4 Explain "insider dealing" and relevant information.

The following are some of the main categories of instances of insider trading cases that have been reported to the Securities and Exchange Commission (SEC) of Sri Lanka.

- Instances where a company's officers, directors and employees have traded in that company's securities after learning of significant, confidential corporate developments, and before such information has reached the public domain;
- When friends, business associates, family members and other "tippees" of a company's officers, directors and employees, have traded in that company's securities after learning of significant, confidential corporate developments and before such information has reached the public domain;
- When employees of law, banking, brokerage and printing firms who were entrusted with significant, confidential information relating to a particular company for the purposes of providing services to that company, have made use of such information before it reached the public domain and traded in the securities of that company;
- When government employees who learned of significant, confidential information relating to a particular company because of their employment in the Government, made use of significant, confidential information before it reached the public domain and traded in the securities of that particular company;
- When people misappropriated and took advantage of significant, confidential information relating to a particular company, which they got to know from their employers, and have made use of such information before it reached the public domain and traded in the securities of that particular company.

(One mark per point, up to a max. total of 4 marks)

(b)

Relevant learning outcomes
8.3.4 Explain enforcement of the Arbitral Award.

The final decision reached by the arbitrators in relation to a dispute referred to the arbitration panel or Arbitrary Tribunal, is known as the Arbitral Award or Arbitration Award. **(1 mark)**

The arbitral award is final and binding on the parties to the dispute. **(1 mark)**

In order to enforce an arbitral award an application must be made to the High Court **(1 mark)** within one year **(1/2 mark)** after the expiry of fourteen days of the making of the award. **(1/2 mark)**

Thereafter, (subject to the provisions regarding the setting aside of the award), the High Court shall, on a day notified to the parties, proceed to file the award **(1/2 mark)** and give judgement in accordance with that award. **(1/2 mark)**

Subsequent to a judgement so given, a decree shall be entered **(1/2 mark)** which shall be enforceable **(1/2 mark)** like any other decree of a civil action.

(Total 6 marks)

Total for Question 05 = 10 marks

Section 2 – Business Taxation

Question 01

Relevant learning outcome/s:
1.2 – taxable income of a company
1.3- gross income tax and balance income tax payable
2.1- dividend tax

1.

i. Statutory income from trade - Y/A 2014/15 (Rs. 000)					Marking Guide
Net profit as per accounts			27,500		
Profit from sale of property, plant and equipment - cancelled				520	0.25
Tax profit from disposal of machinery					
Sales proceeds		1,200			
Less: Tax WDV					
Cost	3,000				
Less: Depreciation claimed					
2012/13	(1,000)				
2013/14	(1,000)	1,000			
		200	-		0.5
Not taxable since there is a qualifying replacement					
Profit from disposal of car					
Not applicable since no depreciation allowance is claimed			-		0.25
Depreciation allowance					
Additions during the year 2014/15					
Machinery					
High tech machinery	3,000 x 50%			1,500	0.5
Imported machinery					
Cost	4,020				
Less: Tax adjusted profit on disposal	(200)				
	3,820				
Depreciation at 33 1/3%				1,273	0.5
Stores building					
Industrial building acquired	3,000 x 6 2/3%			200	0.5

Land - not entitled				-	0.25
Additions in previous years					
Factory building constructed 2012/13	12,800 x 10%			1,280	0.5
Machinery 2012/13 - disposed, thereafter not entitled				-	
Lease rentals on van					
Total lease payable	100 x 48 months	<u>4,800</u>			
Maximum claimed (1/5)		960			
Actual paid	100 x 12	<u>1,200</u>			
Excess paid - disallowed under S.26		<u>240</u>			
Therefore, claimed the maximum limit				960	0.5
Sale of investment property					
Accounting profit from sale - cancelled				2,100	0.25
Not taxable as it is a capital receipt				-	0.25
Intangibles					
Amortization - cancelled			1,000		0.25
Patents - claimed under S.25	8,000 x (1/10)			800	0.5
Software - claim depreciation allowance under S.25					
Locally developed - fully claimed in the previous year				-	0.25
Imported software	1,200 x 25%			300	0.5
Other income					
Dividend received - cancelled				1,440	0.25
Interest income - cancelled				1,962	0.25
Rent income - part of business receipt for a company				-	0.25
Profit from sale of shares in listed companies - exempt under S.13				1,578	0.5
Administration expenses					
Research expenses					
Amount charged - cancelled			2,400		
Cost of research carried out through outsider - claim under S.25	1,000 x 3			3,000	0.25
Other research- claim under S.25	1,400 x 2			2,800	0.25
Gratuity					
Amount charged - cancelled			1,700		0.25
Amount paid - claimed	10,400 + 1,700 - 9,300			2,800	0.25
Repairs					
Repairs on building given on rent					
Amount charged		720			

Less: Maximum claimed	2,400 x (1/4)	<u>(600)</u>			
Excess - disallowed		<u>120</u>	120		0.5
Other repairs - allowed under S.25		-			
Management fees					
Amount charged		13,250			
Less: Maximum claimed		<u>(2,000)</u>			
Excess – disallowed under S.26		<u>11,250</u>	11,250		0.5
Donation - not incurred in the production of income - disallowed			1,300		0.5
Depreciation charge - cancelled			5,200		0.25
Selling and distribution expenses					
Foreign travel					
For promotion of exports - allowed			-		0.25
Others					
Amount charged		1,700			
Less: Maximum claimed	7,800 x 2%	<u>(156)</u>			
Excess - disallowed under S.26		<u>1,544</u>	1,544		0.5
Advertising					
For promotion of exports - allowed			-		0.25
For others – disallowed under S.26	4,350 x 25%		1,087		0.5
Financial expenses					
Interest on finance leasing - cancelled			600		0.25
Share issue expenses-capital expense- disallowed under S.26			120		0.5
			53,821	22,513	
Statutory income from trade			31,308		

ii. Computation of taxable income - Y/A 2014/15 (Rs. 000)				Marking Guide
Profit from trade				
As per (i) above			31,308	0.25
Dividend income				
Not taxable under S.63 since WHT has been deducted			-	0.5
Interest income				
From Treasury bills				
Amount received			1,962	
Add: Notional tax (1/9)			<u>218</u>	0.5
Total statutory income			33,488	0.25

Less: Deductions under S.32				
Tax loss brought forward from 2013/14		28,450		
Less: Claimed	33,488 x35%	<u>(11,721)</u>	<u>(11,721)</u>	1
Tax loss carried forward to 2015/16		<u>16,729</u>		
Assessable income			21,767	0.25
Less: Qualifying payments				
Donation to government hospital		500	(500)	0.5
Donation to approved charity (temple) - disallowed		-		
Donation to approved charity caring for the sick		600	<u>(500)</u>	0.5
Taxable income			<u>20,767</u>	0.25

iii. Gross income tax liability - Y/A 2014/15 (Rs.)				Marking Guide
Tax on taxable income				
On qualifying export profit (31,308,000 x 40%) = 12,523,200				0.5
Taxable at 12%		1,502,784		0.5
On other profit	8,243,800 x 28%	<u>2,308,264</u>	3,811,048	0.5
Tax on dividend distribution				
Gross dividend distributed	8,000,000			
Less: Dividend not taxable				
Paid to unit trust	<u>(400,000)</u>			
	<u>7,600,000</u>			
Taxable at 10%			760,000	1
Tax on distributable profit				
Not liable since the Company has distributed more than 10% of distributable profit for the Y/A 2013/14			0	0.5
Total income tax liability			<u>4,571,048</u>	

iv. Computation of minimum dividend (Rs.)				Marking Guide
Net profit before tax			27,500,000	0.25
Less: Investment in capital assets	7,020+8,460+3,000	(18,480,000)		0.5
Tax on taxable income		(3,811,048)		0.5
			<u>(22,291,048)</u>	
			5,208,952	
Add: Depreciation on additions to property, plant & equipment				
Machinery - high tech	3,000,000 x 12.5%	375,000		0.25
Imported machinery	4,020,000 x 12.5% x (6/12)	251,250		0.25
Stores building	3,000,000 x 10%	<u>300,000</u>		0.25
			<u>926,250</u>	
Distributable profit			<u>6,135,202</u>	
To avoid tax on distributable profit for the Y/A 2015/16				
Minimum amount of dividend to be distributed	6,135,202 x 10%		613,520	0.5
Timing of distribution on or before 30/09/2015				0.5

2.

The Company has received dividend income of Rs. 1,440,000 and the minimum amount of dividend to be distributed to avoid tax on distributable profit is Rs. 613,520. (1 mark)

As such, the Company could distribute the dividend out of dividend received and such distribution is not liable for tax. (1 mark)

3.

The tax impact is as follows.

- i. Tax on taxable income of the Company will reduce as there is an increase in qualified export profits. (1 mark)
- ii. Rate of depreciation allowance on the imported machinery would be at 50% as the export turnover is greater than 60% of total turnover. (1 mark)

(Total : 2 marks)

Question 02

Relevant learning outcome/s :
3.1- partnership
4.1- return on income and distributions ,
5.1-Valu added tax
5.2- Nation building tax
5.3- Economics service charge

1.

A partnership is not a person for the purposes of income tax under the Inland Revenue Act. However, every partnership is chargeable with income tax in terms of Section 78 of the Inland Revenue Act.

The income tax liability is computed on the aggregate of divisible profit and other income after deducting the tax free limit at the specified rate.

Marking Guide
1 mark for addressing chargeability 1 mark for the calculation basis
Total 2 marks

Marking Guide			
1 mark for addressing chargeability mark for the calculation basis		1	
		Total 2 marks	
2. Computation of divisible profit, partnership tax and the distribution among the partners of the partnership - Y/A 2014/15 (Rs. 000)			Marking Guide
	+	-	
Net profit	47,500		
Salary paid to partners - disallowed under S.76			
Anthony	3,600		0.5
David	5,400		0.5
Ground rent allowed under S.76		-	0.5
Depreciation - cancelled	2,240		0.5
Rent paid to partner - allowed as an expense incurred in the production of income		-	0.5
Construction of boundary wall - improvement cost - disallowed under S.26	300		0.5
Cost of entertainment - disallowed under S.26	4,800		0.5
Depreciation allowance			
Furniture - 2012/13 6,200 x 20%		1,240	0.5
Car - used for travelling, not entitled		-	0.5
	63,840	1,240	
Adjusted Profit of Partnership	62,600		
Less: Applicable Export Of Services -Tax Exempt			
(Export Sevices/Total Income)x Adjusted Profit	(23,789)		
Divisible profit	<u>38,811</u>		0.5
3. Computation of income tax liability of the partnership - Y/A 2014/15 (Rs. 000)			Marking Guide
Divisible profit		38,811	0.5
Other income		-	
Total profits and income		38,811	

Less: Tax relief			(1,000)	0.5
Taxable profit			37,811	
Income tax liability at 8%			3,025	1
4. Distribution of divisible profit among partners (Rs. 000)				Marking Guide
	Anthony	David	Total	
Salary	3,600	5,400	9,000	0.5
Balance	17,887	11,924	29,811	0.5
	21,487	17,324	38,811	
Distribution of tax liability among partners (Rs. 000)				
Anthony	3,025 x (21,487/38,811)		1,675	0.5
David	3,025 x (17,324/38,811)		1,350	0.5
5. Computation of VAT liability for the taxable period ended 31/12/2014 (Rs. 000)				Marking Guide
Output tax				
Taxable supply				
Export of services	9,750 x 0%	0		1
Supply of services to exporters (suspended supplies)	3,850 x 12%	462		1
Supply of services to the local market - exclusive of VAT	20,500 x 12%	2,460		1
Total Output tax			2,922	
Less: Input tax				
On cost of furniture	6,200 x 12%	744		0.5
On cost of car (Not deductible since used for travelling)		-	(744)	0.5
			2,178	0.5
Less: Credit voucher obtained for suspended sales		462	(462)	1
VAT payable			1,716	0.5

6. Computation of NBT liability for the quarter ended 31/12/2014 (Rs. 000)				Marking Guide
NBT on sales				
Export of services	9,750	Excepted service		0.5
Supply of services to exporters(Assumed entire services provided is consultancy only)	3,850 x 2%	77		0.5
Supply of services to the local market	20,500 x 2%	410		0.5
NBT payable		487		0.5
Notes				
i. Advance received on rent is not turnover for the purpose of NBT ii. NBT paid on vehicles is not deductible				

7. Any person or partnership whose relevant turnover exceeds Rs. 50,000,000 per quarter is chargeable with ESC. ESC paid by a person/partnership can be set off against the income tax liability of such person/partnership under the Inland Revenue Act. As this is effectively an advance payment of income tax which could be set off against the quarterly income tax liability of a person/partnership, in order to avoid unnecessary cost of compliance, the law was amended with effect from April 01, 2012 to exclude chargeability of ESC from persons/partnerships for the four quarters of a particular year of assessment if they were liable for income tax in the previous year of assessment.

This partnership is not liable for ESC for quarters of 2014/15 if they were liable for income tax for the year of assessment 2013/14. Had they were not liable for income tax in that year of assessment, they will be liable for ESC for quarters of 2014/15.

(Total 3 marks)

8. Partnership will have to submit the Return of Income Tax along with the Financial Statements including the partnership tax computation which includes the following information.
- The partnership profits or losses on trade, business, profession or vacation carried on or exercised by such partnership.
 - Any other income of the partnership
 - The names and addresses of all partners and the apportionment of the divisible profit or loss of the partnership among the partners on their profit sharing ratio.

(any two points 1 mark each = Total 2 marks)