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THE INSTITUTE OF  
**CHARTERED** ACCOUNTANTS  
OF SRI LANKA

# **SUGGESTED SOLUTIONS**

**KB3 – Business Taxation and Law**

**December 2015**

# SECTION 1

## Business Law

### Answer 01

(a)

Relevant Learning Outcome/s:
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1.3.1 Explain the concept of 'organisational personality" and its legal consequences.
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### Suggested detailed answer

The main factor to be determined in ascertaining whether Sandun would be successful in his claim on the fire insurance policy would be to determine as to whether the coconuts belong to the company or its shareholder.

Similar facts were discussed in the case of **Macaura v Northern Assurance** (1925) A.C. 619.

As per the facts of that case, Macaura owned a timber estate. He sold the timber from the estate to Irish Canadian Sawmills Ltd., a company in which Macaura was the sole owner with nominees. He obtained an insurance policy on the timber against fire from Northern Assurance. This policy was obtained in his own name and not in the name of the company. Subsequently the timber was damaged by a fire.

Northern Assurance refused to pay on the fire policy because the timber was owned by the company and not by Macaura. The courts upheld Northern Assurance's argument that the company (Canadian Sawmills Ltd.) was a separate legal entity from its owner Macaura, and therefore it need not pay Macaura any money on the claim.

Therefore when the principle and decision laid down in Macaura's case is applied to the scenario given in the question, it could be said that Sandun will not be able to claim from his fire insurance policy with ABC Insurance PLC for the following reasons:

- The coconuts belonged to the company and not to Sandun.
- The fire insurance policy belonged to Sandun, and not the company, which means that Sandun did not have an insurable interest in the coconuts.
- Sandun and the company are two different legal entities.
- Therefore, the property of the company does not belong to its owner, Sandun.

(5 marks)

(b)

<b>Relevant Learning Outcome/s:</b>
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4.2.1 State the functions of a Company Secretary along with "Panorama case".
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**Suggested detailed answer**

The ruling given in *Panorama Developments Ltd v Fidelis Furnishing Fabrics Ltd* [1971] 2 QB 711, changed the role of the company secretary to being a much more important person nowadays than he was in 1887.

Lord Denning, held that the company secretary is;

- An officer of the company with extensive duties and responsibilities.
- He is no longer a mere clerk of the company.
- He regularly makes representations on behalf of the company and enters into contracts on its behalf, which come within the day-to-day administrative running of the company's business. Therefore, he may be regarded as held out as having authority to do such things on behalf of the company, which means that the company secretary has ostensible or apparent authority to enter into agreements on behalf of the company with third parties.
- As a result, the company secretary is entitled to sign contracts connected with the administrative side of a company's affairs, such as employing staff, and ordering cars, and so forth.

Therefore the statement made by Tommy, is a valid and important one, in the light of the above ruling.

(5 marks)

**(Total: 10 marks)**

## Answer 02

Relevant Learning Outcome/s:	
2.1.1	Compare and contrast between the different types of companies recognised under the Companies Act (including foreign companies doing business in Sri Lanka and listed companies).

### Suggested detailed answer

Section 3 of the Companies Act, allows for the formation of the following types of companies.

- Limited companies
- Unlimited companies
- Companies limited by guarantee
- Offshore companies

Any company, whether incorporated in Sri Lanka or outside Sri Lanka, can make an application to be registered as an offshore company. But such companies are prohibited from carrying on business in Sri Lanka. [264(1)].

Therefore since the UK buyer has insisted that the company should carry on its business in Sri Lanka, this type of company is not suited for Ajith's & Sujith's purposes.

As per Section 3(1)(c) of the Act, a company limited by guarantee, cannot issue shares, but its members will have to undertake to contribute to the assets of the company, in the event of a liquidation, the amounts specified in the company's articles.

This type of company satisfies Ajith's & Sujith's intention of limited liability. But it does not satisfy one main condition of the export order, which is that Ajith & Sujith are to be shareholders of the company.

Therefore, such a company is not suited for Ajith's & Sujith's purposes in this instance.

As per Section 3(1)(b) of the Act, an unlimited company is one which issues shares to its owners, but the shareholders have an unlimited liability to contribute to the assets of the company in the event of the company falling into debt.

Therefore though the first criteria of being shareholders of a company incorporated under the Act is met, it does not meet with the intention of Ajith & Sujith to have only limited liability.

Therefore, this type of company too is not suited for the purposes of Ajith & Sujith as per the given scenario.

Section 3(1)(a) refers to limited liability companies. This type of company issues shares to its owners, and the shareholders' liability to contribute to the assets of the company is limited to the amount they have pledged on their shares.

There are 2 types of limited liability companies under Sri Lankan law. They are public limited companies and private limited companies.

Public limited companies are ones which can offer their shares to the public. This type of company does not satisfy Ajith's & Sujith's requirement to restrict the shareholders to the two of them, and is therefore not suitable for Ajith's & Sujith's purpose.

Private limited companies on the other hand, are ones which have a limited number of shareholders (restricted to a maximum of fifty), and the company's shares cannot be offered to the public. *[Section 27]*

Therefore, in considering the requirement of Ajith & Sujith to have limited liability and to restrict the number of shareholders to the two of them, it seems that the most suitable/best type of company for them will be a private limited company. This type of company also meets the condition imposed by the UK buyer that Ajith & Sujith should be shareholders of the company.

**(Total: 10 marks)**

### Answer 03

(a)

Relevant Learning Outcome/s:
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3.3.1 Analyse the following principles in relation to capital maintenance in a company (redemption, reduction of capital, financial assistance, share buy-back, minority buy-out)
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#### Suggested detailed answer

##### Redemption at the option of the holder of the shares

In the given scenario, the shareholders have given proper notice to the company, requiring the company to redeem their shares, in keeping with the Articles of the company. Therefore, such redemption will take place on the date specified in the notice, which is 31 December 2015.

*[Section 68(1)(a)]*

These shares, which are to be redeemed, will be deemed to be cancelled on the date of redemption, which is 31 December 2015. *[Section 68(1)(b)]*

The company has to settle these shareholders their dues only on 31 January 2016. Therefore until settlement, these shareholders (former) will be ranked as unsecured creditors of the company for the sum payable on redemption. *[Section 68(1)(c)]*

(3 marks)

(b)

Relevant Learning Outcome/s:
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3.3.1 Analyse the following principles in relation to capital maintenance in a company (redemption, reduction of capital, financial assistance, share buy-back, minority buy-out)
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#### Suggested detailed answer

##### Reduction of the stated capital of the company

- In order to reduce its stated capital by a further 15%, SPL must pass a special resolution. *[Section 59(1)]*
- But in order to ensure that the persons dealing with the company are aware of such a decision, the company is required under Section 59 of the Act, to give public notice of the proposed reduction of the stated capital at least sixty (60) days prior to the passing of such resolution. *[Section 59(2)]*
- In the given scenario, SPL has entered into agreements with all its creditors, agreeing to obtain their consent prior to reducing its stated capital. Therefore prior to passing this special resolution, SPL must obtain such consent. If such consent is not obtained, the resolution shall be invalid and of no effect. *[Section 59(3)]*
- As SPL has already redeemed 10% of its stated capital at the option of its shareholders, it must first check whether it has adequate profits or reserves, out of which the redemption may be affected. If not, the Board of Directors should obtain a Certificate of Solvency from its auditors and thereafter pass a board resolution to reduce the stated capital of the company by the amount by which the company would fail to satisfy the solvency test. *[Section 59(4)(a),(c)]*

- Thereafter, this reduction of stated capital with the amount of reduction and the amount of reduced stated capital, must be communicated to the Registrar within ten (10) working days of such reduction. [Form 8]. [Section 59(5)]

(7 marks)

**(Total: 10 marks)**

## Answer 04

(a)

Relevant Learning Outcome/s:
5.2.1 Explain the different types of resolutions which could be passed by the members of a company.

### Suggested detailed answer

Section 144(5) of the Companies Act No. 7 of 2007, allows for a company to pass a resolution of the shareholders, without giving prior notice of such resolution to the shareholders.

Section 144(1) says that, if a resolution is in writing and signed by at least 85% of the shareholders entitled to vote at a meeting of the shareholders, and who together hold at least 85% of the votes entitled to vote on that resolution, then such resolution is treated as validly passed under the Act.

Therefore if the resolution given in the scenario could be put in writing, and is signed by at least 85% of the shareholders, which in this case is all 5 shareholders, then this resolution is treated as passed, even though a meeting of the shareholders was not held and prior notice of such resolution not given.

Therefore, it seems that the company would have adhered to the above provisions of the Companies Act, in order to pass this resolution.

(5 marks)

(b)

Relevant Learning Outcome/s:
6.2.1 Outline the functions of administration/liquidator and receivers/managers.

### Suggested detailed answer

As per Section 184, the directors of the company will have all the powers required to manage the business and affairs of the company. This implies that the directors will have the power to dispose of the land belonging to the company.

In this scenario, the shareholders of the company have agreed to delegate all the powers of the directors to the liquidator. Therefore Dimuthu, as the liquidator, will get all the powers associated with the directors of the company.

Therefore, the liquidator will get the power to sell land, which is specifically to sell the Angoda land of the company.

The liquidator has the power to take custody of the property of the company in Angoda. Further the liquidator has the power to sell immovable property of the company and to transfer the same to any person or company.

The liquidator has the power of executing in the name of the company, the deed of transfer with regard to the sale of this land, as well as to cause the common seal of the company to be placed on such deed.

The liquidator has the power to accept the payment in any form, on behalf of the company, in relation to this sale of land.

The liquidator also has the power to distribute the proceeds of the sale as applicable.

The liquidator has the power to accept shares etc. offered by the buyer in consideration for the sale.

(5 marks)

**(Total: 10 marks)**

## Answer 05

(a)

<b>Relevant Learning Outcome/s:</b>
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7.1.1 Explain the roles of the Securities and Exchange Commission, the Colombo Stock Exchange and the Central Depository System.
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### Suggested detailed answer

(i) Dematerialisation or deposit of securities in the CDS refers to the process of converting the physical share certificate of an investor, to an equivalent number of securities in electronic form and crediting the same in the investor's securities account in the CDS.

(ii) An "**Intra** Account Transfer" is when the account holder in the CDS, changes his/her participant/broker.

An "**Inter** Account Transfer" is when the account holder transfers the securities held by him/her in the CDS, to another account holder outside the trading procedure.

Prior written approval of the SEC should be obtained for this transaction.

(6 marks)

(b)

<b>Relevant Learning Outcome/s:</b>
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8.1.1 Explain the process of mediation.
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### Suggested detailed answer

- Mediation is a mechanism of dispute resolution, which is out of the court system.
- Mediation is a process where the disputing parties engage the assistance of a neutral third party called a mediator to resolve the dispute.
- Mediation is a non-binding mechanism of dispute resolution, where the mediator has no authority to make any binding decisions.
- The process/procedure to be followed in mediation is usually at the discretion of the mediator and the disputing parties themselves.
- The usual practice is that the parties forward to each other and to the mediator, a summary of the key facts and issues on which the dispute revolves and thereafter the parties meet with the mediator to resolve the dispute.
- The mediator uses various procedures, techniques and skills to help the parties resolve their disputes by negotiating an agreement without adjudication.
- The mediator may also be called upon by the parties to provide a non-binding evaluation of the merits of the dispute.
- Legal representatives of the disputing parties are not allowed to take part in the mediation.
- It is not compulsory for either the disputing parties or related third parties (e.g. witnesses), to attend mediation.
- Under the Mediation Boards Act No.72 of 1988, if the value of the claim is less than Rs. 250,000 then the parties must first refer the dispute to mediation, before going to courts.

(4 marks)

**(Total: 10 marks)**

## SECTION 2

### Business Taxation

#### Answer 06

Relevant Learning Outcome/s:
1.2 Taxable income of a company
1.3 Gross income tax and balance tax payable
2.1 Dividend Tax
2.2 Tax on deemed distributions

#### Suggested detailed answer

- (a) Under Section 106(11) of the Inland Revenue Act, separate accounts shall be made only when a person is carrying out **more than one** trade, business, profession or vocation is exercised, and if the profits from such undertaking is **exempt** or **liable at different tax rates**.

In this case, qualified export profits are liable @ 12%, sale of manufacture of computers are liable @ 28% subject to Section 59B which gives a turnover threshold of Rs. 500 million. Since there are two different rates, it is required to maintain records. In this particular case, he did not know about the exact turnover at the commencement of the year of assessment, but only at the end he knew that he has not exceeded the threshold. Hence requirement for maintaining separate records is a must.

(3 marks)

- (b) The computation of tax liability of E-Solution (Pvt) Limited for the year of assessment 2014/15

	Rs. '000	Rs. '000
Profit before tax	78,890	
Less:		
Dividends (net)		1,170
Interest from government securities		720
Book profit from the disposal of computers		150
Insurance receipt		3,000

Add: Disallowable Cancel the entry – book depreciation	3,225	
Building – purchased for Rs. 28,500,000, The purchased building does not qualify for capital allowances. However, subject to certain conditions, capital allowance is claimable. If the building has been acquired from a person who has used the building for any trade business or vocation, then capital allowance @6 <sup>2</sup> /3% can be claimed.		
<u>Tax profit on the disposal of computers</u> Selling price – (cost of acquisition – capital allowance granted) 150,000 – (capital allowance claimed fully) = 150,000	150	
Computers purchased → 1,500,000 x 25%		375
Tax profit on the van Selling price = insurance receipt Insurance receipt – (cost of acquisition – capital allowance granted) 3,000 – (capital allowance claimed fully) = 3,000	3,000	
PAYE tax paid on some of the employees – not allowed	8,460	
Expenditure incurred travelling outside Sri Lanka, solely in connection with the promotion of the export trade of any article or goods, is allowable		
Non-refundable key money written-off to the income statement.	600	
Allowable 600,000 x 8/12		400
(i) Rent paid to the landlord: (150,000 x 12) = 1,800,000 (ii) Rent value of the residence (200,000 + 40,000) = 240,000 Higher of above two is = 1,800,000 Rental value considered for PAYE = 180,000 Expenses of the company over the rental value assigned to employee = 1,620,000 75% disallowed since employment income is more than 600,000.	1,215	
Stamp duty – disallowed	15	
Disbursement on community project	8,600	
Cost of new year compliments	<u>1,760</u>	

	105,915	5,815
<b>Statutory income from trade</b>		<b>100,100</b>
<b>Add: Other sources income</b>		
Net dividend received 1,170,000 (does not form a part of the statutory income)		
Treasury Bill (TB) interest $\frac{720,000}{0.9} = 800,000$		800
<b>Total statutory income</b>		<b>100,900</b>
Less: Deductions under Section 32		-
<b>Assessable income</b>		<b>100,900</b>
Less: Qualifying payments		
Cost incurred on community project, subject to Rs. 10,000,000		8,600
<b>Taxable income</b>		<b>92,300</b>
Tax liability On qualified exports the tax rate is 12%  Manufacture and supply of computers, with a turnover less than 500 million, will be taxed @ 12% Interest income x 28%  $800/100,900 \times 92,300 = 731.8 \times 28\%$ $= 91,568 \times 12\%$		205 10,988
Dividend distribution – assumed distribution was made not out of dividend received $4,200,000 \times 10\%$		420
<b>Total tax liability</b>		<b>11,613</b>
Tax credits:		
Notional tax credit	80	
Dividends tax credit can be given if it is paid SA payments	6,100	(6,180)
<b>Balance tax payable</b>		<b>4,860</b>

(18 marks)

(c)

	<b>Rs.</b>
Book profit	78,890
Add: Depreciation on assets purchased during the year	3,225
Less: Purchase of assets during the year	(30,000)
Tax payments	<u>(11,193)</u>
Distributable profit	<u>40,922</u>
Minimum distribution of 10%	4,092

(4 marks)

**(Total: 25 marks)**

## Answer 07

### Relevant Learning Outcome/s:

- (a) 3.2.2 Explain the chargeability of income tax from charitable institutions, clubs, trade associations and non-governmental organisations.
- 3.2.3 Assess the tax liability of a charitable institution, club, trade association or non-governmental organisation.
- (b) 5.1.3 Assess monthly/quarterly tax payable, taking into account the output tax and input tax.
- 5.2.3 Compute NBT payable by a business of manufacturing, service, wholesale, retail or distributor.
- (c) 5.2.5 State due dates for payment and furnishing returns.
- (d) 4.1.2 Outline the statutory obligations of a company to furnish returns of income and distributions, with due dates.

### Suggested detailed answer

- (a) Computation of the tax liability of Exporters' Association

Total receipts = Rs. 18,623,000

Membership and entrance fee = Rs. 14,542,000

$14,542,000/18,632,000 \times 100 = 78\%$ . Since subscription and entrance fee is more than half of its receipts, it is deemed that the Association is carrying on a business, and the total receipts including membership fees and entrance fees will be the receipts from business.

In such a situation, the Association is liable for income tax on the business income or other income, whichever is higher.

Computation of business income

	Rs.	Rs.
Profit before tax	5,990,000	
Less:		
- Rent received in cash		810,000
- Dividends (net)		180,000
- Fixed deposit interest (net)		360,000
Add: Book depreciation on van	800,000	
No capital allowance for the van since it is used for travelling		

Rates paid for the building given on rent – disallowed	24,000	
Building repair expenditure – on the building given on rent – not allowed	130,000	
Donation	85,000	
Staff loan written off – not allowed	18,000	
Statutory income from the business		5,697,000
Statutory income from rent		
Gross rent 100,000 x 12	= 1,200,000	
Less rates	= <u>24,000</u>	
	1,176,000	
25% for repairs and other expenditure	<u>294,000</u>	
Net rent	<u>882,000</u>	
Statutory income from dividends – does not form part of the statutory income since tax has been deducted		
Statutory income from interest – does not form part of the statutory income since tax has been deducted		

Business income is greater than the non-business income, therefore tax is payable on business income.

Business income = Statutory income = Assessable income	Rs. 5,697,000
Less: Qualifying payments	
Donation to approved charity subject to 75,000 or $\frac{1}{3}$ of AI	Rs. 75,000
Taxable income	Rs. 5,622,000
Tax rate	10%
Tax liability	Rs. 562,200

(11 marks)

(b)

Computation of VAT and NBT liability of the Association

	<b>Rs.</b>
Total taxable supplies liable for the year = (18,632,000 – 810,000 – 360,000 – 180,000)	17,282,000
<b><i>It is assumed that the rent income is received from properties given for residential purposes.</i></b>	
Total taxable supplies for quarter ended 31 March 2015 (17,282,000/4)	4,320,500
Output tax = 4,320,500 @ 11%	475,255
Less: Input tax	(78,000)
VAT payable	397,255
NBT liability = 4,823,000 @ 2%	96,410

(6 marks)

## Alternative answer

	Rs.
Total taxable supplies liable for the year = [18,632,000 – 360,000 – 180,000 – 810,000 + 1,200,000]	
<i>It is assumed that the rent income is received from properties given for commercial purpose, and therefore rent is to be considered on the accrual basis = 1,200,000</i>	19,292,000
Total taxable supplies for quarter ended in 31 March 2015 (19,292,000/4)	4,823,000
Output tax = 4,823,000 @ 11%	530,530
Less: Input tax	(78,000)
VAT payable	452,530
NBT liability = 4,320,500 @ 2%	86,410

- (c) According to the VAT Act, in case of a registered person whose taxable supplies consist of any supplies other than the supply of goods manufactured in Sri Lanka by them, VAT shall be paid for a period from the 1<sup>st</sup> day to the 15<sup>th</sup> day of any month, on or before the end of that month and for the period from the 16<sup>th</sup> day to the end of that month, on or before the 15<sup>th</sup> day of the subsequent month.

The above payments are subject to the final adjustments if any, with the submission of the return. The VAT return has to be submitted on the last day of the month after the expiry of the taxable period.

NBT payable for a month shall be paid on or before the 20<sup>th</sup> of the subsequent month. The return has to be submitted on or before the 20<sup>th</sup> subsequent to the end of the taxable period (quarter). Any person who does not pay VAT and NBT as mentioned above shall be deemed to be in default and will be liable to pay penalties.

(5 marks)

- (d) The Association has not filed its return of income tax for the Y/A 2012/13. This return was due on or before 30<sup>th</sup> November 2013. Non-filing of the return on the due date would result in:
- (i) A penalty of Rs. 50,000, and
  - (ii) Loss of the advantage provided in Section 163(5)(a). Accordingly, the time bar applicable to the Association for an assessment or additional assessment will increase to 4 years from the 30<sup>th</sup> of November of the immediately succeeding year of assessment.

Had the Association filed the return on the due date, the time bar would have been for a period of 2 years from the 30<sup>th</sup> of November of the immediately succeeding year of assessment.

(3 marks)

**(Total: 25 marks)**

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