THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KB3 - Business Taxation and Law

June 2016

SECTION 1

BUSINESS LAW

Question 01

Relevant Learning Outcome/s: 1.2.3 Explain the advantages and disadvantages of incorporation 4.3.1 Discuss the functions, rights and duties of an Auditor (including provisions contained in the Sri Lanka Accounting and Auditing standards Act No. 15 of 1995)

Suggested Detail Answer:

(a) **Advantages of forming a Limited Liability Company**

1. **Independent corporate existence**
   A company is a legal person, which can sue and be sued in its own corporate name.

2. **Ease of raising capital**
   An incorporated company can raise capital by selling its shares, which is a lucrative method of increasing capital as compared to partnerships and sole proprietorships. Also an incorporated company attracts more investors due to its limited liability.

3. **Perpetual succession**
   Stemming from the principle of perpetual succession, the company continues to exist irrespective of any changes in shareholders.

4. **Ownership can be transferred easily**
   Ownership of the company can be transferred easily by selling the shares of the company. In such an instance, the company assets will remain unchanged and owned by the company itself.

5. **Limited liability**
   Unlike a partnership or sole proprietorship, the shareholders of an incorporated company are not liable for the company's debts beyond the value of their shares.

(b) **The rights and duties of an auditor, as specified in the Companies Act, are as follows:**

- Section 162 says, that the auditor is specifically required, to be independent and not to have any conflicts of interest.

  This is to ensure that their judgment is not biased by any interest they have in the company.

- In terms of Section 163, the auditor is required to deliver a statement with the audit report on the existence of any other relationship or any interest in the company or its subsidiaries.

- Under Section 161, if the auditor resigns or ceases to function, as the auditor of the company, he has a duty to deliver a statement to the company of the reasons for his resignation or for the cessation.

- Section 163 requires the auditor to make a report to the shareholders on the financial statements audited by him.

  Such report shall include the basis of opinion, scope and limitation of the audit, whether all required information and explanations were obtained, whether proper accounting records have been kept, whether the financial statements give a true and fair view of the matters, and whether the financial statements comply with the requirements laid down in the Companies Act.

- Section 164 of the Companies Act provides that, an auditor of a company is entitled to have access to the accounting books and other records of the company at all times.

- Further the auditor may require from a director or employee of the company, any information and explanations as he thinks necessary, for the performance of his duties as auditor (Section 164).

- In terms of Section 165 of the Companies Act, the auditor of the company has a right to attend every meeting of shareholders of the company.

- Section 165 also says, that the auditor is entitled to receive the notices and communications that a shareholder is entitled to receive, in relation to a meeting of the shareholders.

- Also the auditor may be heard at a meeting of shareholders which the auditor attends, on any part of the business of the meeting which concerns him as auditor (Section 165).

- The auditor has a right of receiving written notice of at least before 20 working days in the event the company intends to replace him. (Section 160(1) (a)).

- If the auditor is not going to be re-appointed, he has a right to make representations to the shareholders on the appointment of another auditor. (Section 160 (1) (b)).

- If the auditor makes a representation to the shareholders on his removal, he has a right to be paid reasonable fees, and expenses by the company for making representations to the shareholder under the section. (Section 160 (2))

[Total = 10 marks]

Question 02

Relevant Learning Outcome/s:
2.2.2 Explain the process and restrictions in selecting a name 2.5.1 Explain pre-incorporation contracts, implied warranties and ratification.

Suggested Detail Answer:

(a) (i) If the proposed company is a private company, then its name shall read in full as company, "Auto Mart (Private) Limited" or as "Auto Mart (Pvt) Ltd".

(ii) If the proposed company is a limited company, other than a listed company, then its name shall read in full as "Auto Mart Limited" or as "Auto Mart Ltd."

(iii) If the proposed company is a limited company, which is also a listed company, then its name shall read in full as "Auto Mart Public Limited Company" or as "Auto Mart PLC".

[Ref: Section 6]

(b) The kind of contracts entered into by Auto and Mart, on behalf of the proposed company, prior to its incorporation, are known as pre-incorporation contracts.

In terms of Section 24 of the Companies Act, where a person enters into a pre-incorporation contract for and on behalf of a company, that person is deemed to give an implied warranty that,

(a) the company will be incorporated within such period as may be specified in the contract, or if no period is specified, within a reasonable time after the making of the contract**;** and

(b) that the company will ratify the contract within such period as may be specified in the contract or if no period is specified, within a reasonable time after the incorporation of such company.

Therefore the Companies Act not only recognizes pre-incorporation contracts, but makes such contracts legally valid by imposing a requirement to ratify such contracts as mentioned above.

[Total = 10 marks]

Question 03

Relevant Learning Outcome/s:
3.1.1 Analyse types of shares, with reference to stated capital regime, classification, risk, variation of class rights, dividends, voting rights, priority in a winding up. 3.1.2 Compare and contrast the procedures for the issue of shares (including 'issues at a premium or at a discount') 3.4.1 Analyse the following principles in relation to long-term debt capital (classification, risk, interest payments, rights, priority in a winding up)

Suggested Detail Answer:

The following types of shares can be issued by a PLC to the public.

(For the purpose of the examination, any two of the following will be considered for marks)

(a) **Ordinary shares**

The basic form of shares is ordinary shares**.**

Most companies have just ordinary shares.

Subject to the companies articles;

Ordinary shares vest the owner with one vote per share entitlement to participate equally in dividends and if the company is wound up, share in the proceeds of the company's assets after all the debts have been paid.

Holders of ordinary shares have a right to unrestricted participation in the dividends of the company and to the distribution of its remaining property.

The risk is that holders of ordinary shares will be entitled to dividends only if the company makes profits.

Preference shares

Section 49(3) (b) of the Companies Act says that, a Company can issue shares having a ranking above ordinary shares in specified aspects.

Preference shareholders have a priority to a fixed dividend and to a return of capital in a winding up.

These usually confer rights to preferential dividends which may be cumulative or non-cumulative.

The terms relating to preference shares have to be clearly stated at the time of issue

Deferred shares

These shares are issued with limited rights.

In a modern world company the tendency is not to issue deferred shares.

The fact that the deferred shares have no rights to dividends during a particular period does not mean they are not ordinary share capital.

Deferred shares are generally issued to founders or directors of the company.

These shares receive no rights to a company's remaining assets in the event of bankruptcy, until all common and preferred shareholders have been paid.

Non-voting shares

Section 49(3) (c) says that, companies may issues shares which do not carry voting rights at all or which carry limited rights of voting in specified situations as set out in the Articles of Association of the company.

These shares are only issued by a public listed company.

Such shares are usually issued for the purposes of retaining control with the promoters.

Redeemable shares

Redeemable shares are created on the understanding that they will be bought back by the company.

The redemption may be at the option of the company or the shareholder or on a fixed date or upon the occurrence of an event.

The price at which the shares must be redeemed may also be specified either on the basis of a predetermined price or a formula.

(b) **The main disadvantages of raising debt capital are as follows:**

(i) The loan amount and the interest payments can saddle the balance sheet and income statement of the company.

(ii) Any downturn in the business or unexpected capital needs can make it difficult to pay the interest payments on time.

(iii) For some debt instruments, the terms can be complex and may unnecessarily burden the business.

(iv) If the debt is personally guaranteed, liability will extend to non-business assets;

(v) If the company gets into difficulty, the debt financier could become adversarial.

[Total = 10 marks]

Question 04

Part (a)

Relevant Learning Outcome/s:
5.1.1 Compare and contrast the different types of meetings in a company, and their purposes and notice periods.

Suggested Detail Answer:

Section 135 of the Companies Act specifies, that a minimum period of fifteen (15) working days' notice in writing, is required to call an Annual General Meeting of a company.

In terms of section 135(1), any provisions in the Articles of a company which prescribes a shorter notice period than that stipulated in the Act shall be void.

However, section 135(3), allows a company to call an Annual General Meeting with shorter notice than prescribed in the Act, if all the shareholders entitled to attend and vote at such meeting, agree to this shorter notice and

Therefore, in this scenario, if all three of the shareholders, unanimously agree to the giving of short notice for the AGM, then the company can have its AGM in 7 days as planned.

Part (b)

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

Suggested Detail Answer:

Official Receiver

As per the Companies Act, an "official receiver" in the context of a winding up of a company by the court, refers to the official receiver attached to that particular court for insolvency purposes.

If no such official receiver is so attached, the "official receiver" refers to such person as the Minister in charge of the subject, may appoint as official receiver to that court.

An official receiver therefore is an individual appointed to monitor a company for a short period of time, to ensure that as much debt as possible, is paid back to its creditors.

The official receiver is entitled to receive a statement of the affairs of the company, unless the courts direct otherwise. – [Ref: Section 283]

The official receiver is also tasked with the duty of compiling reports as set out in the Companies Act [Ref: Section 284].

He also has the responsibility to submit further reports on matters, which are in his opinion, desirable to be brought to the notice of the court.

[Total = 10 marks]

Question 05

Part (a)

Relevant Learning Outcome/s:
7.1.1 Explain the roles of the Securities and Exchange Commission, the Colombo Stock Exchange and the Central Depository System

Suggested Detail Answer:

The main objectives of the Securities and Exchange Commission (SEC) are as follows:

(i) The creation and maintenance of a market in which securities can be issued and traded in an orderly manner;

(ii) The protection of the interests of investors;

(iii) The operation of a compensation fund to protect investors from financial loss arising as a result of any licensed stock broker or licensed stock dealer being found incapable of meeting his contractual obligations;

(iv) The regulation of the securities market and to ensure that professional standards are maintained**.**

[Section 12 of the SEC Act of Sri Lanka]

Part (b)

Relevant Learning Outcome/s:
8.2.1 Explain the process of conciliation.

Suggested Detail Answer:

The key features of conciliation are as follows:

- Conciliation is one of the methods of alternate dispute resolution.
- In conciliation the parties to a dispute nominate a neutral third party called a "conciliator" to assist the parties reach an agreement.

- Conciliation is consensual and utilises a non-binding adjudication process, which does not involve a court of law.

- In conciliation the parties to the dispute, take an active part in the dispute resolution process, under the guidance of the conciliator.

- Conciliation does not derive any form of judicial power and therefore cannot make any direction that is binding in nature.

- Therefore, the resolution of the dispute and the adherence to the same is entirely in the hands of the parties to the dispute.

- Conciliation takes the form of a "round table settlement negotiation".

(Total = 10 marks)

SECTION 1

BUSINESS TAX

Answer 06

(a)

Relevant Learning Outcome/s:
1.2 Taxable income of a company 1.3 Gross income tax and balance tax payable

Suggested Detail Answer:

SSP PLC Income Tax computation for the year of assessment 2015/16		
	Rs.	**Rs.**
Adjusted profit from trade or business (Note 01)		**49,065,500**
Dividend received - (does not form part of the statutory income)		
Fixed deposit interest (gross) = (1,800,000 x100)/90		2,000,000
Total statutory income		**51,065,500**
Less : Deductions under section 32		
Assessable income		**51,065,500**
Less: qualifying payments		
Donation made to the Colombo National Hospital		400,000
Grocery items – in kind not allowed		
Qualifying payment on expansion 85,000,000 x 25% = 21,250,000		21,250,000
Taxable income		**29,415,500**
Tax liability at 28%		8,236,340
Dividend distribution 5,000,000 x 10%		500,000
Total Tax liability		**8,736,340**
Tax credits		
WHT credit	200,000	
Dividends tax credit	500,000	700,000
Balance payable/refund		**8,036,340**

Note 01	**Rs.**	**Rs.**
Profit before tax	78,252,000	
Less:		
Dividends (net)		880,000
Finance Income		1,800,000
Gross Rent received -part of the business income		
Late payment charges on EPF	71,000	
Management fees paid - 4,820,000: Allowable amount - 1% of the turnover = 6,247,000 or 2 million, whichever is lower. Disallowable amount = 4,820,000-2,000,000	2,820,000	
Donation	500,000	
Royalty is disallowed since it has not yet been paid	500,000	
Bad debts:		
Written off on trade debt –allowed		
Written off on non-trade debt –disallowed	485,000	
Advertisement cost of paper notice to recruit staff is not advertising. Therefore, it is allowed.		
Other Advertising cost: 1,980,000 - 170,000 = 1,810,000 x25% disallowed.	452,500	
Interest paid to its holding company :		
[300,000,000 - (50,000,000 + 45,250,000) x 3]	1,995,000	
[300,000,000 – 285,750,000]X 42,000,000 / 300000000 = 1,995,000 Disallowable interest		
Book depreciation	14,105,000	
Depreciation Allowances - Assets acquired for expansion project		
Construction of the building - 20,000,000 x 10%		2,000,000
Machinery purchased + installation cost (57,000,000 + 3,500,000) x 33 1/3%)		20,666,666
Furniture 4,500,000 x 20%		900,000
Depreciation Allowances - For assets acquired during the Y/A		
Machinery (53,505,000-8,000,000)=45,505,000 x 33 1/3% =		15,168,334
Power generating machine - 8,000,000 x 100%		8,000,000
Furniture used in residencies is not qualified for claiming D/A		
Office furniture (4,500,000-2,000,000)=2,500,000*20%		500,000
Computer hardware 400,000 x 25%		100,000
Computer software, locally developed x 100%		100,000
	99,180,500	**50,115,000**
Adjusted trade profit		**49,065,500**

(b)

Relevant Learning Outcome/s:
2.1.1. State the meaning of dividend from the context of Inland Revenue Act.

Suggested Detail Answer:

"dividend" includes;

(1) **any distribution of profit** by a company to its shareholders , in the form of–

- (i) money or of an order to pay money
- (ii) shares in any other company; or
- (iii) debentures in that company or in any other company; or
- (iv) scrip dividend or dividend in specie ; or
- (ii) where a company buys back shares from its shareholders, the excess, if any, paid to any shareholder over the market price of such share quoted in the Colombo Stock Exchange or the market value of such share as the case may be, as at the date on which the shareholders of such company at a meeting approved such share buyback; and

(2) the amount of any **capital returned or distributed to the extent of the paid up** value of any shares distributed by the company to its shareholders **within six years preceding** the date of such return or distribution of capital, **such paid-up value representing the capitalization** of the whole or any part of the profits of the company**.**

(5 marks)

Answer 07

(a)

Relevant Learning Outcome/s:
5.1.3 Assess monthly/quarterly tax payable, taking into account the output tax and input tax.
5.1.4 Apply knowledge on a given set of exempted supplies, in computation of output tax and claimable input tax.
5.1.6 State due dates of payment, furnishing returns and provisions applicable to refunds

Suggested Detail Answer:

Output Tax	Rs.
Liable supplies 627,540,000 x 70% = 439,278,000 x11%	48,320,580
Exempt supplies 627,540,000 x 30% 188,262,000 - No VAT	-
Total output tax	**48,320,580**
Input Tax	
Imports	
Import of raw materials	33,232,000
Imported machine	1,230,000
Import of motor vehicle - No VAT	-
Local purchase	
Other materials and accessories purchased from registered persons - 34,000,000 x 11%	3,740,000
VAT paid on other expenses	4,100,000
Total input tax	42,302,000
Input disallowed - entertainment	(750,000)
Total input tax claimable	**41,552,000**

Input tax disallowed on exempt supplies

= Total input tax claimable - inputs on imports = inputs other than on imports

41,552,000 **- 33,232,000** **=** 8,320,000

= $\dfrac{\text{Exempt supplies x Input tax}}{\text{Total supplies}}$

$$\frac{188{,}262{,}000 \times 8{,}320{,}000}{627{,}540{,}000} = 2{,}496{,}000$$

Allowable input tax for the period = 41,552,000 - **2,496,000** = 39,056,000
Claimable input tax including B/F
input tax = 39,056,000 + **1,543,000** = 40,599,000
VAT payable for the period = output tax – input tax
48,320,580 - 40,599,000 = 7,721,580
Less: VAT Paid
On 20th October 2015 Rs. 2,260,000 - not allowed
On 20th November 2015 Rs. 1,780,000
On 20th December 2015 Rs. 2,360,000 (4,140,000)
Balance Payable **3,581,580**

(10 marks)

(b)

Relevant Learning Outcome/s:
3.2.2. Explain the chargeability of income tax from charitable institutions, clubs, trade associations and non-governmental organisations.

Suggested Detail Answer:

Charitable institution	Club
Income tax liability arises on the sources of income they are not exempt.	If more than 75% of the total receipts of the club is from members, then Investment income is chargeable to income tax. If it is less, then club is considered as doing a business. In such a case business income and investment income both are taxable.
If a charitable institution maintains savings accounts, interest from such savings accounts is exempt if it is less than Rs. 5,000 per month.	A club does not enjoy such exemption.
If the charitable institution maintains children, elderly and disabled persons in the home itself, and satisfies the Commissioner General that the interest is solely applied for the maintenance of such inmates the interest is exempt.	Club does not have the kind of exemption.
Charitable institutions are granted Rs. 500,000 as allowance under section 33.	Clubs do not have such allowance.

(8 marks)

(c)

Relevant Learning Outcome/s:
4.1.2. Outline the statutory obligations of a company to furnish returns of income and distributions, with due dates.

Suggested Detail Answer:

The return of income should be submitted if the **company is chargeable** to income tax irrespective of whether it receives a return of income from the Inland revenue Department or not. The return should be submitted in the **specified form** and with all **necessary particulars** and schedules, and it should be submitted on or before **November 30th** of the subsequent year of assessment.

Further, any company which carries on any trade or business is required to file a return irrespective of the fact that it enjoys any tax exemption or tax holiday.

When it comes to the return on dividends, it should be submitted whether dividends have been distributed or not, and it should be submitted twice per annum. For the six month period from 1st April to 30th September, return should be submitted on or before **October 31st,** and for the period relating to October 1st to March 31st, return should be submitted on or before **April 30th.**

(**4 marks)**

(d)

Relevant Learning Outcome/s:
5.3.1. Explain the circumstances under which a business is liable to ESC, including thresholds.

Suggested Detail Answer:

Economic Service Charge is payable on relevant turnover by persons or partnerships other than unit trusts or mutual funds, cooperative societies, Central bank of Sri Lanka, public corporations which get funds from the government**.** The relevant turnover is calculated after aggregating all the receipts from trade, business, profession or vocation and after removing any amount relating to bad debts written off , VAT component, sale proceeds etc., and if such turnover exceeds Rs. 50 million threshold per quarter. However, the liability arises if the person or partnership does not have taxable income or does not enjoy any tax exemption in the previous year.

(3 marks)

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