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THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KE3-Fundamentals of Taxation & Law

September 2016

Part A

Taxation

SECTION 1

Answer 01

1.1

Learning Outcome/s: 3.1.2

Explain specific adjustments applicable to the computation of statutory income of a company, from rent, interest, dividend and profit from trade or business (other than adjustments applicable to intercompany transaction)
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Correct answer: B

1.2

Learning Outcome/s: 5.1.4

Explain the due dates of payment and submission of returns.

Correct answer: A

1.3

Learning Outcome/s: 3.1.5

Explain the tax liability of a company on distribution.

Correct answer: A

1.4

Learning Outcome/s: 5.2.3

Compute tax payable in a straight-forward, non-complex scenario.
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Correct answer: B

1.5

Learning Outcome/s: 1.1.1

Functions and principle of taxation

Correct answer: C

(Total: 10 marks)

Answer 02

2.1

Learning Outcome/s: 2.1.3

Explain the meaning of "person", year of assessment, sources of profits & income and the "residence rule".

During any year of assessment if any individual is physically present in Sri Lanka for more than 183 days that individual shall be deemed to be resident in Sri Lanka throughout that Y/A.

2.2

Learning Outcome/s: 3.1.4

Compute gross income tax liability and balance tax liability of a small or medium-sized company.

Taxable income	450,000
Tax rate	12%
Gross tax liability	54,000
Less: Tax credits	
ESC brought forward	(10,000)
SA payments	<u>(40,000)</u>
Balance tax payable	<u>4,000</u>

2.3

Learning Outcome/s: 4.1.2

State the consequences of non-compliance.

- A penalty could be imposed
- An estimated assessment could be issued
- A court case could be filed

2.4

Learning Outcome/s: 4.5.1

Explain characteristics of withholding tax schemes (WHT on director fees, interest, dividends, sale of gems at auctions, lottery and other prizes) and tax credits where applicable.

$$\begin{aligned} \text{PAYE liability} &= 420,000/0.84 = 500,000 \\ &(500,000 - 420,000) = \text{Rs. } 80,000 \end{aligned}$$

2.5

Learning Outcome/s: 5.2.2

List a few excepted articles and services.

Excepted services specified in the First schedule of PART II of the Nation Building Act:

- (i) Supply of electricity
- (ii) Medical services
- (iii) Supply of water
- (iv) Transport of goods or passengers
- (v) Exhibiting films in a cinema
- (vi) Supply of locally developed software
- (vii) Any other services provided in the excepted services schedule to the Act

(Total: 10 marks)

SECTION 2

Answer 03

Learning Outcome/s: 2.2 Statutory income form sources of profits & income listed in the Inland Revenue Act 2.3 Total statutory income, assessable income and taxable income 2.4 Gross income tax and balance tax payable		
Computation of Income tax payable by Lalith for the year of assessment 2015/16		
	Exempt/ not liable (Rs.)	Liable (Rs.)
Employment income		
Salary → 176,000 x 12		2,112,000
Residential benefit		
(i) Rent paid to the landlord 60,000 x 12 = 720,000		
(ii) Rental value = RA + rates = 50,000 + 5,000 = 55,000		
(iii) Higher of (i) and (ii) = 720,000		
(iv) Since employment income is more than Rs. 1,800,000, it is restricted to Rs. 180,000		
(v) Lesser of (iii) and (iv) = Rs. 180,000		180,000
Life insurance premium		90,000
Vehicle allowance 50,000 x 12 = 600,000 Exempt – Rs. 50,000 per month (600,000)	600,000	-
Statutory income from employment		2,382,000
Rent income		
Gross rent received 120,000 x 12 = 1,440,000		
Less: Rates	<u>20,000</u>	
	1,420,000	
Less: 25% for repairs	<u>355,000</u>	
Net rent	<u>1,065,000</u>	
NAV = 100,000 Net rent is more than NAV Therefore net rent is taxable		1,065,000
Interest income		
• Rs. 63,000 from Treasury Bills does not form part of the statutory income	63,000	-
• Rs. 24,000 received from a savings account during the year → no withholding tax has been deducted. It is exempt since it is from a savings account and monthly interest is less than Rs. 5,000.	24,000	-
Profit from sale of shares in listed companies – exempt	102,000	

Business income			
Net profit as per accounts	2,069,000		
<u>Add/(less)</u>			
Book depreciation → computer	80,000		
Capital allowance → 60,000 x 25%	(15,000)		
Book depreciation → photocopy machine	40,000		
Capital allowance → 120,000 x 33 ¹ / ₃ %	(40,000)		
Rent paid in advance is disallowed 480,000 - 384,000 = 96,000	96,000		
Interest	1,223,000		
Donation	10,000		
Adjusted profit	3,463,000		3,463,000
Total statutory income			6,910,000
Less: Deductions under Section 32 Interest paid on a loan taken to construct the building - allowed Nothing can be deducted from employment income. However, Lalith has enough other sources of income, and therefore interest payments can be deducted			(1,223,000)
Assessable income			5,687,000
Less: Qualifying payments Donations to temple-not a qualifying payment Life policy premium → 90,000 Limited to ¹ / ₃ of AI or 75,000, whichever is less Payment for community project -1,200,000 (this is limited to a maximum of Rs. 1 million) Nothing can be deducted from employment income. However, Lalith has enough other sources of income, and therefore qualifying payment can be deducted. Qualifying payments on employment income Personal allowance			(75,000) (1,000,000) (250,000) (500,000)
Taxable income			3,862,000
First Rs. 500,000 @ 4%	20,000		
Next Rs. 500,000 @ 8%	40,000		
Business income Rs. 2,230,000 @ 10%	223,000		
Next Rs. 500,000 @ 12%	60,000		
Balance Rs. 132,000 @ 16%	21,120		
Gross income tax payable	364,120		
Less: Tax credits			
Self-assessment	100,000		
PAYE	103,440		
Balance tax payable	160,680		Total:20 Marks

Part B
Legal Fundamentals
SECTION 1

Answer 04

4.1

Learning Outcome: 5.1.1
Explain the circumstances under which a relationship of Principle-Agent would be recognised by mutual agreement, by ratification, by necessity and by estoppels.
Correct answer: B

4.2

Learning Outcomes: 1.4.1 and 1.4.2
1.4.1 Explain the regulatory role of each of these institutions. 1.4.2 Institute of Chartered Accountants of Sri Lanka, Sri Lanka Accounting Standards Monitoring Board, Securities and Exchange Commission, Colombo Stock Exchange, Board of Investment, Registrar of Companies, Dept. of Customs, Central Bank (Exchange Control aspect).
Correct answer: C

4.3

Learning Outcome: 7.2.1
Explain the entitlement of gratuity.
Correct answer: D

4.4

Learning Outcome: 8.2.1
State briefly on each of these Acts: Prevention of Money Laundering Act. No. 05 of 2006, Electronic Transaction Act No. 19 of 2006, Computer Crimes Act. No. - Consumer Protection Act, Intellectual Property, Act. No. 36 of 2003.
Correct answer: B

4.5

Learning Outcome: 6.3
Leasing
Correct answer: A

(Total: 10 marks)

Answer 05

5.1

Learning Outcome: 2.4.1

Explain the manner in which a contract could be discharged by performance, agreement, frustration and breach (including anticipatory breach).

A contract can be terminated in the following ways:

- By its performance
- By a subsequent agreement to terminate it
- By a termination notice
- By an actual breach of a condition in the contract
- By an anticipatory breach of the contract
- By frustration
- By the operation of the law:
 - * Due to insolvency of a party
 - * Due to bankruptcy of a party
 - * Due to a prescription period
 - * Due to an inferior right being merged with a superior right
 - * When an important term of the contract has been altered or cancelled by one party, without the other party's knowledge.

5.2

Learning Outcome: 1.1.1

Identify the main branches of the Sri Lankan legal system and their roles.

Case law refers to the decisions made by the Superior Courts.

Case law as a source of law means that these decisions serve as laws. In other words, decisions given in a case will be binding on similar cases.

Case law is also known as "judge-made law", "un-enacted law" or "judicial decisions".

5.3

Learning Outcome: 7.3

Shop & Office Act

The following places are recognised as shops under the Act:

- A place where a retail or wholesale business is carried on
- A residential hotel
- A place where the business of sale of articles of food or drink takes place
- A place where the business of a barber or hairdresser is carried out
- A place where any other prescribed trade or business is carried out

5.4

Learning Outcome: 8.2.1

State briefly on each of these Acts: Prevention of Money Laundering Act. No. 05 of 2006, Electronic Transaction Act No. 19 of 2006, Computer Crimes Act, Consumer Protection Act, Intellectual Property Act No. 36 of 2003.

The main features of a freezing order are:

- It is an order prohibiting any transaction in relation to an account, property or investment, which is or has been used in committing money laundering.
- For a freezing order to be effective, it must be confirmed by the High Court.
- Generally, a freezing order is valid for a period of 7 days, unless it is extended by the High Court.
- Whilst a freezing order is in place, any transaction affecting an account, property or investment, to which the freezing order applies to, shall be null and void.

5.5

Learning Outcome: 3.6.1

Identify the differences between a CIF contract and a FOB contract.

Some of the main duties of a seller in a CIF contract are:

- To ship the goods of the description contained in the contract.
- To procure a contract of carriage by sea, under which the goods will be delivered to the destination, contemplated by the contract.
- To arrange for an insurance policy that will be available for the benefit of the buyer.
- To prepare an invoice for the goods.
- To tender, within a reasonable time after shipment, the bill of lading, the certificate of insurance and the invoice to the buyer, so that the buyer may obtain delivery of the goods if they arrive, or recover for their loss if they are lost during the voyage.

(Total: 20 marks)

SECTION 2

Answer 06

Learning Outcome: 2.1.1

Explain the requisites of a valid contract i.e. offer and acceptance, intention to create legal relations, considering (including the concept of "Laesio Enormis", "capacity and form", Definition of contract agreement, offer and acceptance capacity to contract, form of contracts, "reality of consent".

(a)

Varuna is a minor as he is less than 18 years of age.

Generally, a minor cannot enter into legally binding contracts.

But an exception to the general rule is that, a minor can enter into legally binding contracts, if such contracts are for his educational purposes, and such contracts are not detrimental to the minor.

In this instance, the proposed contract is a contract of apprenticeship, which means that Varuna will be taught the practical aspects of law.

Therefore such contracts can be entered into by a minor, and will be held binding on the minor.

Hence, Varuna can enter into the proposed apprenticeship contract with his uncle Karu.

(b)

This scenario is similar to the facts of the decided case of *Neale v Merrett [1930] WN 189*.

In this scenario, there is a valid offer.

For a valid contract to be formed, there should be a valid acceptance by Ravi, which is absolute and unqualified.

But the acceptance given by Ravi, is qualified and conditional, and varies from the original offer. This amounts to a counter offer.

The counter offer or conditional acceptance results in terminating the original offer.

Therefore, a valid contract has not been formed in this instance between Mani and Ravi.

(Total: 10 marks)

Answer 07

(a)

Learning Outcome: 3.2.1

Explain the implied conditions and warranties that are applicable in a contract for sale of goods.
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The implied terms on the title of the goods sold, for both an outright sale and an agreement to sell are:

- In the case of a sale, there is an implied condition on the seller that he has a right to sell the goods.
- In the case of an agreement to sell, there is an implied condition on the seller that he will have a right to sell the goods at the time the property in such goods passes onto the buyer.
- There is an implied warranty that the buyer shall have and enjoy quiet possession of the goods.
- There is an implied warranty that the goods shall be free from any charge or encumbrance, which was not known to the buyer before the contract was made.

(b)

Learning Outcome: 3.4.1

Explain the remedies that are available to a buyer and seller, including rights of an "unpaid seller".
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(i) This right of lien is applicable in the following instances:

- When the goods have been sold, without any stipulation as to credit.
- When the goods have been sold on credit, but the term of credit has expired.
- When the buyer has become insolvent.

(ii) This right of lien is lost to the unpaid seller in the following situations:

- When he has delivered the goods to a carrier or bailee, in order to be transmitted to the buyer, without reserving the right of disposal of goods.
- When the buyer or his agent lawfully obtains possession of the goods.
- When this right has been waived.

(Total: 10 marks)

Answer 08

(a)

Learning Outcome: 5.4.1

State the liability of agents for acts done whilst acting within actual authority within ostensible authority and without authority.
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Similar facts were discussed in the decided case of *Drew v Nunn* [1879] 4 Q.B.D. 661.

In that case, the court decided that the husband was liable to pay for the cost of the food purchased by wife.

Generally, the mental incapacity of the principal terminates a contract of agency.

But the principal will be bound by contracts made by his agent with third parties who have had no notice of the principal's incapacity.

Therefore, Anura is liable to pay for the goods purchased from Sour Food Centre by Sunitha on credit.

(b)

Learning Outcome: 5.7.5

State the relationship between partners.
--

In partnership law, subject to the partnership deed, the consent of all the partners is necessary to introduce a new partner.

The partnership deed, which is signed and entered into by all the partners, acts as the governing constitution of the partnership.

It lays down, amongst others, the rights and duties of the partners of that particular partnership.

In the given scenario, Kevin could not prevent Susith from being a partner, as the particular clause in the partnership deed operated as Kevin's consent.

(Total: 10 marks)

Answer 09

(a)

Learning Outcome: 6.1.3

Explain the applicable principles in a contract of insurance relating to uberrimae fidei, curable interest and indemnity (including total and partial insurance).

A person wishing to obtain an insurance policy has to fill out an application or proposal form given by the insurance company.

If the answers to the questions in that form are untrue in relation to a material fact, the insurance policy so obtained becomes voidable, at the option of the insurer.

A very important aspect of all contracts of insurance is that a duty is imposed on the person applying for the insurance cover to exercise “utmost good faith” (uberrimae fidei) in all his declarations to the insurer. This principle of uberrimae fidei means that a person seeking the insurance owes a duty to disclose to the insurer every material fact, which he knows or ought to know about the insurance, so that the insurer can properly evaluate the risk that he is undertaking.

As per the given facts, even though the application did not ask whether previous applications had been rejected or not, such a fact is a material fact as it helps the insurer to evaluate the risk properly.

Therefore, the non-disclosure of this amounts to a breach of the principle of uberrimae fidei by Peter.

Therefore, the policy could be set aside.

(b)

Learning Outcome: 4.2.1

Explain, in respect of the following, the applicable principles of cheque law and their commercial significance (endorsements, crossings, dishonour and banker's liability)

(i) **The legal effect of a crossing on a cheque**

A cheque is crossed when **two parallel lines** are drawn across it. In addition, words may be written within the parallel lines.

The effect of a crossing on a cheque is that it acts as a direction to the paying bank that the cheque should be paid only through a bank account and not over the counter.

(ii) **Different types of crossings**

Some of the main types of crossings used in practice are:

General crossing

When a cheque bears across its face an addition of two parallel transverse lines, either with or without the words "and company" or "not negotiable", that addition constitutes a general crossing.

Special crossing

When a cheque bears across its face an addition of the name of a banker, either with or without the words "not negotiable", that addition constitutes a special crossing.

Not negotiable crossing

When a person takes a crossed cheque, which bears on it the words "not-negotiable", he does not get a better title to the cheque than that which the person from whom he took it had.

Account payee crossing

Even though the Bills of Exchange Ordinance does not refer to this type of crossing, it is a practice recognised by the banking community. When these words are written within the parallel lines across a cheque, it serves as a notice to the banker that only the account of the payee should be credited.

(Total: 10 marks)

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