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THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KB3 - Business Taxation and Law

December 2017

SECTION 1

BUSINESS LAW

Answer 01

(a)

Relevant Learning Outcome/s: 1.3.3

Explain the concept of the 'veil of incorporation'.

Study text reference: Pages 11 and 12

Similar facts as given in the scenario were discussed in the case of **Macaura vs Northern Assurance** (1925) A.C. 619, where it was laid that as Macaura did not own the goods, but only the company, he had no 'legal or equitable relation to the goods', and his relation was to the company.

The facts of this case were as follows

Macuara owned a timber estate. He was also the sole shareholder of Irish Canadian Saw Mills Ltd. He sold timber from the estate to this company. He also obtained a fire insurance policy against this timber, but the policy was obtained in his own name. The timber got caught in a fire and the insurers, Northern Assurance, refused to pay the claim.

The same principle as Macuara's case applies in this scenario.

Maniq will not be entitled for the insurance claim under this policy

The reason being that:

- the estate belonged to the company and not to him
- the insurance policy was in his name and not in the company's name (in other words the insurable interest in the estate was with the company and not with Maniq).
- the company is a separate legal entity from that of its owner

Note: Any other case which establishes the separate legal personality of a company will be considered for marking.

(b)

Relevant Learning Outcome/s: 4.1.1

Explain the following terms in relation to the directors of a company appointment, retirement and removal, powers, duties and liabilities, civil and criminal liabilities.

Study text reference: Page 74

In terms of section 206, subject to the Articles, a director may be removed by ordinary resolution at a meeting, where prior notice of such removal has been given.

Once such notice is given, the concerned director has the right to make representations within 14 days of such notice, and the company is required to circulate the same to its shareholders or read it at the meeting, unless the company obtains permission from court not to do so.

(Total: 10 marks)

Answer 02

(a)

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
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Study text reference: Page 25

A company limited by guarantee, is one which does not issue shares, and its members undertake to contribute a specified amount towards its assets in the event of a liquidation.

A private limited company is one where the number of shareholders is restricted to 50 and issuing of shares to the public is prohibited.

As the Companies Act provides for a single shareholder to incorporate a private limited company [Section 4(2)], the 1st requirement of Benjamin can be satisfied by a private limited company.

Benjamin's 2nd requirement of having a limited number of shareholders in the future too can be easily satisfied by a private limited company.

Therefore, from the two types of companies Benjamin is considering, the most suitable type of company for him would be a private limited company.

(b)

Relevant Learning Outcome/s: 2.5.3

Explain the indoor management rule and the doctrine of constructive notice.

Study text reference: Page 38

- *"A person dealing with a corporation has no obligation to ensure that a corporation has gone through any procedures required by its articles, by-laws, resolutions, contracts, or policies to authorize a transaction or to give authority to a person purporting to act on behalf of the corporation."*

This principle is known as the 'indoor management rule', and was laid down in the case of Royal British Bank v Turquand.

- In this instance Asha is not expected per the indoor management rule to ensure that the resolution has been passed by the company by following the proper procedures, and hence can assume that the CEO has been given the due authority to sign the contract on behalf of the company.
- As a result the contract so signed is valid and binding on the company.

(Total: 10 marks)

Answer 03

(a)

Relevant Learning Outcome/s: 3.2.2

Explain the importance of "Solvency Test" and capital maintenance mechanisms.

Study text reference: Page 52

To pass the solvency test in terms of section 57 of the Companies Act, it should be established that the company is able to pay its debts as they become due in the normal course of business; **and** that the value of the company's assets is greater than the aggregate value of its liabilities and its stated capital.

In the given scenario,

- The 1st condition of being "able to pay its debts as they become due in the normal course of business" has been fulfilled by the company per the confirmation received from the auditors.
- To determine whether the company has fulfilled the 2nd condition, the following calculation is considered:
 - Total assets = Rs. 100,000
 - Total liabilities + stated capital = Rs. 105,000
 - Therefore total assets are less than the aggregate of total liabilities and stated capital.
 - Therefore the 2nd condition has NOT been fulfilled by the company.
- As a result the company has failed its Solvency Test.

(b)

Relevant Learning Outcome/s: 3.5.2

Outline the principles relating to "majority rule" and "minority protection" (including "Oppression, Mismanagement and derivative action and Major Transactions) (S.185 of the Companies Act)

Study text reference: Page 62

Per the given data:

- $\frac{1}{2}$ of the total assets of DPL = Rs. 5,000,000
- Value of the land proposed to be acquired = Rs. 8,000,000
- Rs. 8,000,000 > Rs. 5,000,000

Therefore per section 185(2)(a), the proposed transaction falls within the definition of a major transaction.

In terms of section 185(1), a company shall not enter into any major transaction, unless such transaction is:

- (a) approved by special resolution
- (b) contingent on approval by special resolution
- (c) consented to in writing by all the shareholders of the company, or
- (d) a transaction which the company is expressly authorised to enter into by a provision in its articles, which was included in it at the time the company was incorporated

(Total: 10 marks)

Answer 04

(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.

Study text reference: Page 92

- In terms of section 134 of the Companies Act, shareholders holding not less than 10% of the shares with voting rights can make a request to call for an extraordinary general meeting to discuss any issue.
- Upon receipt of such request, there is a statutory duty cast upon the directors to call an Extraordinary General Meeting (EGM) within 15 working days after the date of such requisition.
- Section 134(1) requires that the meeting must be held within 30 working days after the deposit of this requisition.
- But under section 135(1)(b) if five (5) working days' notice in writing is given (i.e. a shorter notice), it will serve the purpose since Kandurata Tasty Tea Ltd is a private limited company.
- Also in any other meeting other than an AGM if it is so agreed by the shareholders having a right to attend and vote at the meeting being shareholders together holding shares which carry not less than ninety five (95) per cent of the voting rights, each issue to be considered and voted duly at that meeting be deemed to have been duly called a meeting (Section 135 (3) (b)).
- The request to hold the meeting must contain the issues to be considered at the meeting and the notice of the meeting must specify the issues in order to enable the shareholders to decide whether it is in their interest to attend.
- If the directors do not call a meeting within 15 working days of the deposit of the requisition, the requisitionists or those representing more than half of the voting rights of all of the requisitionists may call a meeting (provided that any meeting so convened shall not be held after the expiration of three months).
- In such event all reasonable expenses incurred in convening such a meeting must be repaid by the company.

(b)

(i)

Relevant Learning Outcome/s: 6.1.1

Differentiate "compulsory and voluntary winding up" and explain their consequences.

Study text reference: Page 114

Section 271 of the Companies Act sets out that a company is deemed unable to pay its debts in the following situations.

- Where the company has failed to pay, secure or compound an admitted debt exceeding Rs. 50,000, which is payable to a creditor within three weeks of the creditor serving a demand on the company to pay back the relevant sum owed.
- Where any execution or other process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied, in whole or in part.
- Where it is proven to the satisfaction of the court that the company is unable to pay its debts.

(ii)

Relevant Learning Outcome/s: 6.2.1

Outline the functions of administration/liquidator and receivers/managers

Study text reference: Page 121

Section 383 states that a creditor of a company under liquidation cannot be appointed as its liquidator.

As Wishwa Pinto is the main creditor of the company, he is prohibited by section 383, to act as the liquidator of the company.

(Total: 10 marks)

Answer 05

(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.

Study text reference: Pages 142 and 143

The following services are offered by the CDS:

- Opening of client accounts
- Deposit of shares
- Withdrawal of shares
- Transfer of shares
- Settlement
- Rights and share splits
- Share repurchases
- Corporate entitlements
- Takeovers & mergers
- Providing statements to CDS account holders (monthly, quarterly or annually)
- Record keeping
- Transmissions and nominations

(b)

Relevant Learning Outcome/s: 8.3.4

Explain enforcement of the Arbitral Award

Study text reference: Page 166

For the enforcement of an arbitral award, an application must be made to the High Court within one year after the expiry of fourteen days of the making of the award.

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 and give judgement in accordance with that award.

Subsequent to a judgement so given, a decree shall be entered which shall be enforceable like any other decree of a civil action.

(Total: 10 marks)

SECTION 1

BUSINESS TAXATION

Answer 06

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

ABE Export (Pvt) Limited
Income tax computation for Y/A 2016/17

	Rs.	Rs.
	+	-
Net profit per accounts	19,140,000	
Less:		
Interest income – other source of income		5,760,000
Exchange gain – liable income and part of business income		
Dividend income – other source of income		125,000
Provision for the gratuity fund	1,083,000	
Cash payment made		872,000
Training costs not allowed since they are not directly relevant at the commencement of the training.	287,000	
Provision for medical insurance – not allowed (per the Act, no provision is allowed)	1,940,000	
Provision for staff bonus – not allowed since no provision is allowed	1,258,000	
Staff recruitment cost – allowed		
Vehicle maintenance (3,668,000 – 360,000) – allowed since it is used for the business		
Ground rent payable (360,000) – not allowed since the payment has not been made yet	360,000	
Depreciation on motor cars – disallowed	2,028,000	
Charity and donation – disallowed	59,000	
Foreign travel cost – disallowed since it is not connected to earned profit. Further, in the previous year of assessment there were no profits.	1,105,000	
Gifts and presents cost – disallowed	55,500	
Bad debt written-off (trade) – allowed		
Bad debt written-off (not trade) – disallowed	172,000	
Bad debt (general provision) – disallowed	567,000	
Landline connection charges – not incurred in the production of income	162,000	
Profit from the disposal of the motor lorry		760,000

Sale proceeds – (cost of acquisition – capital allowance granted) = 4,600,000 – (5,800,000 – 2,320,000)		
Tax profit	1,120,000	
Bank guarantee charges in respect of a personal loan – disallowed	272,000	
Lease interest:	300,000	
(i) $\frac{1}{5}$ of lease value 180,000 * 48/5 = 1,728,000		
(ii) Amount paid = 1,620,000		
Allowable amount is lesser of (i) or (ii)		1,620,000
Interest expense on related party loan taken from the holding company → Rs. 14,800,000		
(Stated capital + Reserves) x 4/loan amount * Interest expense = (3,000,000 + 1,850,000) x 4/14,800,000 * 875,000 = 1,146,960 → allowable amount, therefore no adjustment is needed.		
Unrecoverable tax expenses	382,000	-
	30,290,500	9,137,000
Adjusted profit from trade or business		21,153,500
Statutory income from trade		21,153,500
Add: other sources income		
Interest income from treasury bills (5,760,000/9 x 10)		6,400,000
Net dividend income does not part of the statutory income		-
Total statutory income:		27,553,500
Less: Deductions under Section 32		
(i) Brought forward loss = 1,450,000		
(ii) 27,553,500 x 35% = 9,643,725		
Allowable amount is lesser of (i) or (ii)		(1,450,000)
Assessable income		26,103,500
Less: Qualifying payments		
Donation made to an approved charity (Allowable amount is lower of 59,000, 1/5 of the assessable income or 500,000)	59,000	(59,000)
Taxable income		26,044,500
Tax liability		
Business income = 21,153,500 * 12%	2,538,420	
Interest income = 4,891,000 * 28%	1,369,480	3,907,900
Tax credits		
WHT credit on treasury bills	640,000	
Self-assessment payment	2,000,000	-
ESC payment	300,000	
Total credits		<u>2,940,000</u>
Balance payable		967,900

(Total: 25 marks)

Answer 07

Relevant Learning Outcome/s: 3.1, 4.1.3, 5.1 and 5.2

- 3.1 – Partnership
- 4.1.3 – Furnishing of returns by partnerships
- 5.1 – Value Added tax,
- 5.2 – Nation Building Tax

(a) (i)
Computation of divisible profit of Success International for Y/A 2016/17

	Rs.	Rs.
	+	-
Net profit per accounts	5,300,000	
Less:		
Other sources of income excluded / exempt income		
- Interest income		292,500
- Income earned from the Maldivian hotel (service rendered in SL to a person outside SL) - exempt		875,000
Add: Salaries paid to partners:		
- Rodney	800,000	
- Vikum	800,000	
- Nalani (since she is a working partner, salary is allowed)	-	
Amortisation of non-refundable deposit - Disallowed	1,500,000	
Lump sum payment attributable for 2016/17 - allowed (6,000,000/5)		1,200,000
Rent paid to Vikum - allowed	-	
Books donation to university - disallowed (allowed for partners as QP)	125,000	
Interest paid on loan to construct a building - disallowed when ascertaining trade profit	175,000	
	8,700,000	2,367,500
Less: Share of profit relating to working partner is considered as part of the remuneration, which is deductible. <i>1/5 of the net profit (assumed that share of profit is calculated based on accounting profit → 5,300,000/5)</i>		1,060,000
Tax adjusted profit of the partnership		5,272,500
Less: Deductions		
Interest paid on loan obtained to construct a building		(175,000)
Divisible profit		5,097,500
Interest income will not be part of other income as WHT has been deducted		-

Total		5,097,500
Less: Tax-free limit		(1,000,000)
Taxable income		4,097,500
Tax at 8% (4,097,500 x 8%)		327,800

Distribution of divisible profit among the partners	Total	Rodrigo	Vikum
Salaries paid to partners	1,600,000	800,000	800,000
Share of profit	3,497,500	1,748,750	1,748,750
Divisible profit	5,097,500	2,548,750	2,548,750

- (ii) Rodney, as the precedent partner of Success International, is required to send a return of the partnership to the Department of Inland Revenue on or before 30th November 2017 showing the following:
- Profit or loss of the partnership ascertained per provisions of the IRD Act
 - Other income of the partnership
 - Names and addresses of all the partners
 - Apportionment of the divisible profits or losses of the partners according to the profit sharing ratio, taking into account of the salaries and other remuneration of the partners and any interest on the partner's capital
 - Apportionment of other income in accordance with shares in the partnership

(b) (i)

OUTPUT TAX			
Taxable supply			
Income earned from survey reports (3,375,000 – 875,000)	2,500,000	15%	375,000
Zero-rated supply			
Designing of survey plan for a Maldivian hotel	875,000	0%	-
Exempt supply			
Student registration fees and educational courses fees	5,500,000	Exempt	-
	8,875,000		375,000
INPUT TAX			
Taxable supply			
Input tax relating to taxable supply		160,000	
Common input tax	100,000		
Exempt supply			
Disallowable input tax pertaining to exempt supply (5,500,000/8,000,000) x 100,000	(68,750)	31,250	
Allowable input tax			191,250
VAT PAYABLE			183,750

- (ii) According to the VAT Act, in the 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 1st day to the 15th day of any month **on** or before the end of that month **and** for the period from the 16th day to the end of that month **on** or before the 15th 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.

- (iii) The partnership is liable to pay NBT for the quarter ended 31 March 2017 as the liable turnover exceeds Rs. 3 million.

Computation of NBT liability			
Liable turnover			
Student registration fees and educational courses fees	5,500,000	2%	110,000
Income earned from survey reports	2,500,000	2%	50,000
Designing of survey plan to a Maldivian hotel	875,000	Excepted service	-
NBT payable			160,000

(Total: 25 marks)

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