THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC 3 - Corporate Taxation

December 2018

SECTION 1

Answer 01

Relevant Learning Outcomes: 2.1, 2.2, 2.3, 6.3 and 6.4
2.1 Assessing income tax liability of a non-resident person
2.2 Remittance tax
2.3 Double tax treaties
6.3 Taxation and ethics
6.4 Professional risk

(a) Per Section 69(4) of the Inland Revenue Act No. 24 of 2017 (IRA), DMS–India, which is a company incorporated outside Sri Lanka, is considered a non-resident for income tax purposes in Sri Lanka. Per Section 4 of the IRA, in the case of a non-resident person, the person's income from employment, business, investment or other source for a year is assessable for income tax to the extent that the income "arises in or is derived from a source in Sri Lanka". DMS–India receives several payments from DMS–SL, which has a source in Sri Lanka. The tax implications on receiving these payments are set out below.

(i) **Visa application fee**
The visa application fee is not income of DMS–India. The visa application fee is the income of the MoFA. As such DMS–India is not liable to pay income tax on this income.

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(ii) **Service fee**
The service fee is not income of DMS–India but rather income of DMS–SL. As such DMS–India is not liable to pay income tax on this income.

(iii) **Royalty**
As a result of the trademark and trade name agreement, DMS–India receives a royalty payment from DMS–SL for the use of the trademark and trade name. Section 195 of the IRA defines the term "royalty" as *"a payment, including a payment of a premium or like amount, derived as consideration for –*

(a) ……………….

*(b) the use of or right to use a patent, **trade mark**, design or model, plan, or secret formula or process*

(c) ………..."

As such the payment made under the trademark and trade name agreement can be considered a payment of royalty.

Section 73(1) of the IRA provides a list of payments that have a source in Sri Lanka. According to Section 73 (1)(c) *"interest, charges, annuities, **a royalty,** technical service fee or similar payment, if paid by a resident person, other than as expenditure of a business carried on by the resident person through a permanent establishment outside Sri Lanka,* is considered a payment that has a source in Sri Lanka.

Accordingly the royalty payment made by DMS–SL (which is a company incorporated/registered in Sri Lanka, and is a resident in Sri Lanka) has a source in Sri Lanka. As such DMS–India will be required to pay income tax on such royalties in Sri Lanka.

Per Section 88(1)(d) the royalty payment received by DMS–India, which does not have a permanent establishment (PE) in Sri Lanka, will be considered a final withholding payment and subject to a withholding tax of 14% per Section 84(1)(a) and the First Schedule to the IRA. Therefore DMS–Sri Lanka will be obliged to deduct the withholding tax when making the royalty payment to DMS–India.

However, there is a double tax treaty between Sri Lanka and India (DTA). Paragraph 2 of Article 12 of the DTA provides for a lower withholding tax rate of 10% as follows.

"However, such royalties or fees for technical services may also be taxed in the Contracting State in which they arise, and according to the laws of that State, but if the beneficial owner of the royalties or fees for technical services is a resident of the other Contracting State the tax so charged ***shall not exceed 10 per cent*** *of the gross amount of the royalties or fees for technical services*."

As the beneficial owner of the licensed mark is DMS–India, and as it is a company incorporated in India (and assuming that DMS–India satisfies the requirements of Section 75 of the IRA), the royalty payment made by DMS–SL to DMS–India will be eligible for the lower withholding tax rate of 10% in Sri Lanka**.**

(iv) **Capital repayment**

Capital repayment received by DMS–India is not an income arisen in or derived from a source in Sri Lanka. As such it will not be subject to any income tax in Sri Lanka.

(v) **Interest**

Per the loan agreement DMS–India receives interest from DMS–SL for the loan issued. Section 195 of the IRA defines the term "interest" to include,

"(a) a payment, including a discount or premium, made under a debt obligation that is not a repayment of capital".

As such the payment made under the loan agreement is considered interest/investment income and per Section 73 (1)(c) it has a source in Sri Lanka. Accordingly, the interest payment made by DMS–SL (which is a company incorporated/registered in Sri Lanka, and is a resident of Sri Lanka) and received by DMS–India is subject to income tax in Sri Lanka.

According to Section 88(1)(d) the interest payment received by DMS–India will be considered a final withholding payment and subject to a withholding tax of 5% per

Section 84(1)(a) and the First Schedule to the IRA. Therefore, DMS–SL will be obliged to deduct the withholding tax when making the interest payment to DMS–India.

Per paragraph (2) of Article 11 of the DTA, a lower withholding tax rate of 10% is provided for interest payments as follows.

"However, such interest may also be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged ***shall not exceed 10 per cent*** *of the gross amount of the interest."*

However, as the IRA provides for a withholding tax rate of 5%, which is lower than the maximum tax rate stipulated in the DTA, the 5% rate can be applied.

(b)

(i) **Visa application fee**

As the visa application fees are collected on behalf of the MoFA and such fees are not accounted as income of DMS–SL, the amount remitted to the MoFA will not be allowed as a deductible expense unless the corresponding income is recognised in the books of DMS–SL.

(ii) **Service fee**

The service fees collected by DMS–Sri Lanka is its main income and it is not an expense to be deducted.

(iii) **Royalty**

DMS–Sri Lanka can deduct 100% of the royalty payment for tax purposes, provided it had deducted the 10% withholding tax from such royalty and remitted the same to the Department of Inland Revenue (DIR).

(iv) **Capital repayment**

Not a deductible expense in Sri Lanka.

(v) **Interest**

DMS–Sri Lanka can deduct the interest payment for tax purposes, subject to Section 12 (interest expense) and Section 18 (deductible amount of financial cost), and provided it had deducted the 5% withholding tax from such interest and remitted the same to the Department of Inland Revenue (DIR).

(c)

Sri Lanka has entered into a Double Tax treaty ("DTA") with India. Article 23 of that DTA provides:

1. *The laws in force in either of the Contracting States shall continue to govern the taxation of income in the respective Contracting States except when any provision to the contrary is made in this Agreement.* ***When income is subject to tax in both Contracting States, relief from double taxation shall be given in accordance with the following paragraphs of this Article.***

2. *In India:*

   (a) *Where a resident of India derives income which, in accordance with the provisions of this Agreement, may be taxed in Sri Lanka, India shall allow as a deduction from the tax on the income of that resident, an amount equal to the tax paid in Sri Lanka.*
   Such deduction shall not, however, exceed that portion of the tax as computed before the deduction is given, which is attributable, as the case may be, to the income which may be taxed in Sri Lanka.

   (b) *Where in accordance with any provision of the Agreement income derived by a resident of India is exempt from tax in India, India may nevertheless, in calculating the amount of tax on the remaining income of such resident, take into account the exempted income.*

Accordingly, DMS–India can claim a tax credit in India (its home country) for the taxes paid in Sri Lanka in respect of royalty and interest, against the taxes payable in India on the same income. Such a credit cannot exceed the taxes payable in India on the same income.

In order to claim the tax credit, a letter confirming the amount of tax deducted must be obtained from the Department of Inland Revenue.

(d)

(i) As Sunil Associates has been appointed the auditor, being appointed as the authorised agent for tax purposes will create threats to the independence of the firm. The threats created in such a situation most often will be self-review, self-interest and advocacy threats.

(ii) Tax return preparation involves assisting the client with their tax reporting obligations by drafting and completing the information, including the amount of tax due (usually on standard forms) required to be submitted to the applicable tax authorities. Tax return preparation services are generally based on historical information and principally involve analysis and presentation of such historical information under existing tax law, including precedents and established practices. Further, the returns are subject to review or an approval process by the tax authorities. Accordingly, providing such services does not generally create a threat to independence if the management takes responsibility for the returns including any significant judgments made.

(iii) Section 126(4) of the IRA provides,
"A taxpayer or the taxpayer's duly authorised agent, shall sign the return, attesting to its accuracy and completeness."

Therefore, the person signing the return will be considered attesting the "accuracy" and "completeness" of the return. Providing such an assurance means that the partner is required to provide "absolute assurance". Although the partner may be performing the audit of DMS–SL, due to the inherent limitations of the audit, he/she will not be able to provide "absolute assurance". As such the Partner will not be in a position to sign the return.

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes: 3.1, 3.2, 4.2 and 5.2
3.1 Statutory provisions
3.2 Case law
4.2 VAT on financial services
5.2 Transfer pricing

(a)

Calculation of VAT on financial services
For the year ending 31 March 2019

	Turnover	Non-financial services	Financial services
	Rs. '000		
Per the financial statements			
Interest income			
Interest income on easy payment	34,500	-	34,500
Interest income on HP	1,200	-	1,200
Interest income on lease	56,100	4,100	52,000
Interest income on treasury bill	3,600	-	3,600
Interest income term deposits	7,200	-	7,200
Interest income on loan	112,300	-	112,300
Overdue interest	8,500	425	8,075
	223,400	**4,525**	**218,875**
Other operating income			
Commission income	100	100	
Income from land sale	11,000	11,000	-
Documentation charges	5,400	5,400	-
Rent income	12,500	12,500	-
	29,000	**29,000**	**-**
Total income	**252,400**	**33,525**	**218,875**
		%	**Rs.**
Turnover: Financial services		86.72%	218,875
Turnover: Non-financial services		13.28%	33,525
Total turnover			252,400

Alternative answer

	Rs. '000
Total turnover	Rs. 252,400
Non-financial services	
Interest income on leases	Rs. 4,100
Overdue interest	Rs. 425
Other operating income	Rs. 29,000
	Rs. 33,525
Financial services	**Rs. 218,875**

Financial services as a % = Rs. 218,875/Rs. 252,400 * 100 = 86.72%

Computation of tax on supply of financial services

				Rs.'000
Operating profit/loss (before income tax expense)				54,350
Add:				
NBT on supply of financial services charged to the income statement				1,160
VAT on supply of financial services charged to the income statement				9,350
				64,860
Add:				
Emoluments payable				
E.P.F. and E.T.F.	1,425			
Gratuity	900			
Staff salaries	17,500			
Staff allowances	1,500			
Staff incentives	210			
Director fee	4,200			
Staff medical and accident insurance	650			26,385
Book depreciation				4,300
Less:				
Economic depreciation				-
B/F			2,800	
Current year				
- Furniture and fittings	960	12.5%	120	
- Office equipment	1,200	12.5%	150	
- Software	2,000	25%	500	(3,570)
Total value addition prior to tax				**91,975**

Value addition attributable to financial services (91,975 x 86.72%)			79,761
Less:			
VAT and NBT on supply of financial services *(value addition prior to tax attributable to financial services/117*17)*			(11,589)
Value addition attributable to supply of financial services			**68,172**
Tax on supply of financial services @ 15%			**10,226**

(b)(i)

Per Section 90(1) of the IRA, installment (tax) payers should pay the tax by quarterly installments based on the assessable income he derives or expects to derive during the year of assessment from a business.

According to Section 91 the installments should be based on estimates (either original or revised) of tax payables.

The installments of tax should be paid on or before the 15th day of August, November and February respectively in that year of assessment, and the 15th day of May of the succeeding year of assessment.

However, according to the transitional provisions set out in Section 203(5) the quarterly installments for the year of assessment 2018/19 can be calculated as follows.

	Rs. '000
Income tax liability of YA 2017/18	28,000
Increment of 5%	1,400
Total uplifted liability	29,400
WHT credit	(300)
Quarterly installments paid (Q1 and Q2)	(11,000)
Balance payable for the year of assessment (Q3 and Q4)	18,100
Per quarter	9,050

According to the above calculation the quarterly installments paid for the first two quarters are lower than the actual payable. This may leads to penalties. Per Section 179(2) of the IRA, if a tax payer fails to make quarterly installments within fourteen days of the due date, he shall be liable to a penalty equal to 10% of the tax due (tax in default).

According to Sections 157 and 159, if the amount of tax is not paid by the due date, the company shall be liable to pay interest at a rate of 1.5% per month or part month, compounded monthly, during the default period, in addition to the penalty of 10%**.**

(c) Section 77 of the Inland Revenue Act (IRA) No. 24 of 2017 deals with the domestic transactions between associate enterprises.

The IRA defines an associated enterprise as follows.

A person shall be an associated enterprise of another enterprise, if one person participates directly or indirectly or through one or more intermediaries in the management, control the capital of the other person – Section 77(5)(a).

As such, since RPPL is a fully-owned subsidiary of QFPLC, RPPL and QFPLC are associated enterprises.

Any transactions between associated enterprises should be carried out at arm's length prices.

Arm's length price means for the purposes of ascertaining income, gain or profits arising in, derived or accruing from or losses incurred in any transaction, operation or scheme entered into between two associated enterprises calculated in accordance with arm's length price, as that where a connected transaction is carried out taking into account the terms and conditions that would have been used in a comparable independent transaction – Section 77(5)(e).

If it appears to an assistant commissioner in the course of his audit, that any transactions between associated enterprises had not taken place at arm's length price, he/she may initiate a transfer pricing audit – Section 77 (2)(a).

The likelihood of transfer pricing scrutiny may depend on the following facts and circumstances.

- RPPL is a loss-making company while QFPLC pays taxes
- RPPL borrows funds only from QFPLC, which always offers comparatively lower rates than the market rate
- All mortgage loans related to the properties sold by RPPL are provided by QFPLC

In order to avoid the risk of being subject to any transfer pricing audits we advise the transactions between the two companies to be carried out at arm's length price determined,

(i) in accordance with the arm's length principal, and
(ii) on the basis of application of the most appropriate method

(Total: 25 marks)

SECTION 2

Answer 03

Relevant Learning Outcomes: 1.1, 1.2, 3.3, 4.4 and 5.3
1.1 Comprehensive income tax computations
1.2 Impact of taxation on business and finance decisions
3.3 Application of statutory provisions and case law
4.4 Managing VAT in a business
5.3 Tax planning

Theater World (Pvt) Ltd
Computation of income tax payable for year of assessment 2018/19
Based on projected accounts for the financial year ending 31 March 2019

	Note	Rs. '000
Net profit before taxation (per accounts)		54,940
Add:		
Profit from sale of theatre equipment (tax)	**6**	5,000
Net loss on investment in FVTPL *(S11(2))*		58
Entertainment tax paid – allowed as it is not a specified levy *(S10(1)(b)(x))*		-
Performance incentive paid to the CEO – disallowed as it is not considered for PAYE purposes *(S10 (2))*		6,200
Travelling – relates to the marketing director's visit to a foreign university – disallowed *(S10(1)(b)(i) and S11)*		350
Fines and penalties *(S10(1)(b)(iii))*		850
Provision for gratuity *(S10(1) (b)(viii))*		1,750
Staff training – relates to a foreign degree followed by the marketing director – disallowed *(S10(1)(b)(i) and S11)*		1,900
Donations *(S11)*		900
Entertainment expenses		470
Depreciation (per accounts)		42,775
Security charges – disallowed and claimed against investment income		600
Advertisement/business promotion – allowed *(S11)*		-
Repairs and maintenance		
- Renovation of pastry shop building given on rent disallowed	**1**	800
- Projector repair	**1**	200
- Office maintenance	**1**	-
Amortisation of intangible asset (per accounts)		250
Amortisation of leasehold land – allowed		-

Writing off of receivables		1,955
Bank loan interest – on unused building	**2**	17,000
Balance bank loan and OD interest – utilised loan – can be claimed in full *(S18)*	**2**	-
		81,058
		217,056
Less:		
Rent income – from commercial building – taxed separately as investment income *(S7(2)(a))*		(8,900)
Rent income – from pastry shops – this business income as it is effectively connected to the business *(S6(2)(g))*		-
Profit from sale of theatre equipment (per accounts)		(3,000)
Gratuity paid	**3**	(519)
Depreciation allowances	**5**	(12,667)
Amortisation of intangible assets (taxed)		-
Interest from fixed deposits (gross) – taxed separately under investment income		(8,000)
Interest from loan given to PHPL – taxed separately under investment income		(4,117)
Gain on realisation of quoted public company shares – exempt		(2,500)
Profit exempt under S24A of the Inland Revenue Act No. 10 of 2006	**4**	(2,440)
		(42,143)
Assessable income from business		**93,855**

Computation of assessable income from investment

	Rs. '000	Rs. '000
Interest from fixed deposits (gross)		8,000
Interest from loan given to PHPL		4,117
Rent income	8,900	
Less: Security charges relating to rent	(600)	
It is assumed that no other expenses are applicable to rent income	-	8,300
Assessable income from investment		**20,417**
Total assessable income		
- Assessable income from business		93,855
- Assessable income from investment		20,417
Total assessable income		**114,272**
Less: Qualifying payments and relief S52		
Donation made to the government		(830)

Taxable income		**113,442**
Income tax liability @ 28%		31,764
Less: Tax credits		
ESC b/f		(2,758)
WHT paid on interest from fixed deposits	**7**	(400)
10% WHT on rent income	**7**	(1,320)
Balance tax payable		**27,286**

Note 1: Repairs and improvements

		Rs.'000
Repairs and maintenance (per accounts)		3,215
Less: Renovation of pastry shop given on rent and fully depreciated	Disallowed as no TWDV for previous year and improvement is of capital nature.	(800)
Less: Repairs to projectors	Disallowed as no TWDV for previous year and added to depreciation base.	(200)
Office maintenance	Allowed	2,215

	Rs.'000
Cost	2,345
Less: Depreciation over 5 years	469
WDV as at 31 March 2019	1,876
Add: Unclaimed repair allowance	200
Depreciation base for 2019/20	2,076

Note 2: Bank loan and overdraft interest

	Rs'000.
Bank loan and OD interest	92,676
Less: Interest relates to loan obtained to construct the theatre in NP – disallowed *(S12(a))*	(17,000)
Balance can be claimed fully *(S18)*	**75,676**

	Rs.'000
Finance cost	75,676
Total borrowings (long term, short term and OD)	524,565
SC + reserves	477,160
Four times of SC + R (service organisation)	1,908,640
terest allowed upto	302,704
Actual interest is below the restriction specified in S18. Accordingly the full finance cost except for the Rs. 17 million can be claimed.	

Note 3: Gratuity paid

	Rs.'000
Opening balance as at 1 April 2018	7,769
Add: Provision for the year	1,750
Total	9,519
Closing balance as at 31 March 2019	9,000
Gratuity paid	519

Note 4: Calculation of exempt profit under Section 24A of the Inland Revenue Act No. 10 of 2006 (per the transitional provision under the Inland Revenue Act No. 24 of 2017 such exemption will continue until 2022/23)

	Rs.'000
Net profit	8,040
Add: Accounting depreciation on theatre equipment (24,000,000 x 10%)	2,400
Less: Depreciation allowance on theatre equipment (24,000,000 x 33.33%)	(8,000)
Exempt profit	**2,440**

Note 5: Depreciation allowance for 2017/18

Description	Year	Cost	Rate	Amount
		Rs.'000	%	Rs.'000
Building	2017/18	38,000	10.00%	3,800
Building – WIP	2018/19	100,000	Not claimable	-
Building – not yet used	2018/19	15,000	Not claimable	-
Theatre equipment – not exempt from tax under S24A	2017/18	24,000	33.33%	8,000
Projectors	2017/18	1,194	33.33%	398
Projectors	2018/19	2,345	Over 5 years	469
Motorcycles		1,000	Cannot be claimed	-
Total				**12,667**

Note 6: Taxable profit/loss on theatre equipment disposal

		Rs.'000
Sale proceeds		9,000,000
Less: TWDV		
Cost	12,000,000	
Depreciation allowance	(8,000,000)	4,000,000
Assessable charge		5,000,000

Note 7: WHT paid at source

		Rs.'000
Interest from fixed deposits (gross)	8,000 x 5%	400
Rent income (gross)	13,200 x 10%	1,320
Total		**1,720**

(b)

TWPL is involved in the production, importation and distribution of movies. Accordingly, the entire revenue for Y/A 2018/19 was generated via ticket collections from owned theatres, non-owned theaters and e-ticket sales.

Further, TWPL has generated a commission income from film production and film distribution. Other income mainly comprises retail sales of food and beverages, and sponsorships. In addition to that in Y/A 2018/19 the company generated rental income and derived a gain from an asset disposal.

Identification of taxable/exempt supplies

Per item (xvii) of paragraph (b) of Part II of the First Schedule to the VAT Act, "supply of any film, for distribution or exhibition" is exempt from VAT.

Further, per item (xxviii) of paragraph (c) of Part II of the First Schedule to the VAT Act, for "cine films, cinematographic films exposed or developed, magnetic cine sound recorders, cinematographic cameras and projector parts and accessories, apparatus and equipment for cinematographic laboratories, electric filament or discharge lamps, arc lamp carbon, speakers, amplifiers, digital stereo processors and accessories, cinema media players and digital readers, identified under the Harmonised Commodity Description and Coding System Numbers, for custom purposes with the approval of the Chairman, National Film Corporation," are exempt from VAT at the point of import.

The industry norm is that income earned from ticket collection is distributed among the film producer, cinema hall owner and distributor in the ratio 45:45:10.

- **Ticket collection revenue and commission income:** the entire income generated through ticket collection and film production and distribution commission is exempt from VAT.

- **Foods and beverage sales:** per the VAT Amendment Act No. 20 of 2016, with effect from 02/05/2016, wholesale and retail supply is chargeable to tax if the total value of supply including exempt supply is more than Rs. 12.5 million for any three consecutive months. Accordingly, TWPL is liable to pay VAT on the retail sales of food and beverage inside the cinema.

- **Rent income:** liable for VAT

- **Disposal of assets**: As the theater equipment disposed of related to an exempt supply, the sale proceeds of such disposal is not subject to VAT.

Claiming input tax

Per Section 22 of the VAT Act, input tax is deductible only on expenditure attributable to taxable supplies and not on exempt or excluded supplies. Any common input tax should be proportioned between the liable and exempt/excluded supplies using an appropriate criterion such as turnover, square area etc.

Accordingly, the company cannot claim any input tax in respect of the expenses directly attributable to the ticket collection and commission revenue, as they are exempt supplies for VAT purposes, and the applicable portion of the common input tax on ticket collection and commission revenue cannot be claimed for the same reason. Hence in preparing the VAT return, the portion of input tax relating to the exempt supplies (ticket collection and commission revenue) has to be disallowed.

(c) Tax implications relating to the three proposals

(i) **Increase the stated (share) capital through issue of shares**

Per the Inland Revenue Act No. 24 of 2017 (hereafter referred as IRA), which was effective from 1 April 2018, the following provisions need to be considered in deducting interest expenses attributable to financial instruments (bank loans, finance leases, bank overdraft etc.)

Per Section 12 of the IRA, the relevant debt obligation should be incurred for the following purposes in order for the interest expense to be allowed for tax purposes:

1. The borrowed money should be used to acquire an asset that is used during the year in the production of income, and/or
2. The borrowed money should be incurred in the production of income

In addition to Section 12 mentioned above, provisions of Section 18 (which restrict the deduction of interest) also need to be considered when deducting interest expenses. Per the thin capitalisation rules applicable after 1 April 2018, any financial costs deducted in calculating an entity's income from conducting a business or an investment for the year of assessment, shall not exceed the amount of financial costs attributable to financial instruments within the limit specified.

The limit applicable to a manufacturing entity is 3 times the issued share capital and reserves, and the limit applicable to a non-manufacturing entity is 4 times the issued share capital and reserves.

Accordingly, in the case of TWPL, which is a non-manufacturing entity, the interest expense deductible subject to the application of thin capitalisation rules relating to a particular year of assessment is calculated as follows.

A/B x C = D

A. Total financial cost

B. Total cost of financial instruments

C. Total of the issued share capital and reserves (other than reserves arising from the revaluation of assets) x 4 times

D. Allowable finance cost attributable to finance cost

Accordingly, if the stated capital is increased via the issue of shares, the allowable interest component too will increase to the advantage of the company.

(ii) **Acquisition of the theatre equipment and projectors on a finance lease for the new cinema that is under construction**

Per Section 16(2) of the IRA, capital allowances are:

- granted in respect of depreciable assets owned and used by a person at the end of a year of assessment in the production of the person's income from a business; and
- calculated in accordance with the provisions of the second or fourth schedule to the IRA

A depreciable asset is defined as "an asset to the extent to which it is employed in the production of income from a business and which is likely to lose value because of wear and tear, obsolescence or the passing of time; but excludes goodwill, an interest in land, a membership interest in an entity and trading stock."

Accordingly, the following condition has to be satisfied when claiming capital allowances in respect of any depreciable assets.
- Ownership of the asset should be available to the relevant person – legal ownership or ownership of the asset in any other way as specified in the Act.

Per Section 49(2), if an asset is acquired on a finance lease, the ownership of the asset gets transferred to the lessee.

Accordingly, even though the asset is acquired under a finance lease TWPL is entitled to claim capital allowances on such asset. However, the relevant lease interest charged to the income statement will be disallowed subject to the thin capitalisation rules as stated earlier.

(iii) **Value the investment assets as at 30 September 2017 and incorporate those valuations in the financial statement of the previous year of assessment (2017/18) as the year-end audit of that year is yet to be carried out.**

Per the provisions of the IRA, a gain from the realisation of an investment asset is chargeable to income tax as a capital gain.

Section 195 of the IRA defines investment assets and the capital assets as follows.

Investment asset:
(a) means a capital asset held as part of an investment, but
(b) excludes the principal place of residence --------

"Capital asset"
(a) means each of the following assets:
  (i) land or buildings
  (ii) a membership interest in a company, partnership or trust
  (iii) a security or other financial asset
  (iv) an option, right or other interest in an asset referred to in the foregoing paragraphs; but
(b) excludes trading stock or a depreciable asset

Per Section 203(4) – transitional provisions – the cost of an investment asset held by a person as at 30 September 2017 is equal to the market value of the asset at that time.

The capital gain is computed as follows.

Capital gain/(loss) = Consideration received (Section 38) – cost of the asset (Section 37) or if purchased before 30 September 2017, market value as at 30 September 2017 (Section 203 (4)).

Accordingly, the cost of the investment assets acquired prior to 30 September 2017 can be considered as the market value of those assets as at 30 September 2017 at the time of the realisation of the investment asset for the purpose of computing the capital gain, whether such value is incorporated in the 2017/18 accounts or not.

(d)

(i) **Sale of land in Rosmead Place**

Per Section 6(2)(g) of the IRA, amounts derived that are effectively connected with the business and would otherwise be included in calculating the person's income from an investment, are considered as part of business income.

As mentioned above, Section 195 of the IRA defines investment assets and capital asset as follows.

Investment asset:
(a) means a capital asset held as part of an investment, but
(b) excludes the principal place of residence --------

Capital asset:
(a) means each of the following assets:
    (i) land or buildings
    (ii) a membership interest in a company, partnership or trust
    (iii) a security or other financial asset
    (iv) an option, right or other interest in an asset referred to in the foregoing paragraphs; but
(b) excludes trading stock or a depreciable asset

Per the definition of a capital asset, it includes land or building and excludes trading stock or a depreciable asset.

Even though the land is a capital asset, which is not a depreciable, and was acquired with the intention of constructing a cinema and not with the intention of resale, based on the available facts, information and reasons (selling within a short period of time, dividing into plots, existence of profit motive) and decided cases given below, it could be construed that the gain from the sale of the land is not a capital gain, which is subject to tax at 10%, but rather a part of business profit liable to tax at 28% per Section 6 stated above. Under this scenario land could be considered part of the trading stock

Per the previous Inland Revenue Act, a capital gain was not a taxable source. However, according to Section 217 of the said Act, "trade" has been defined to include every adventure or concern in the nature of trade. Accordingly, it includes profit from isolated transactions when such transactions are in the nature of trade.

Per Ram Iswara Vs CIR:
• the transaction was concluded within a short period of time • there was preparation to sell the land dividing the land into lots and a sketch was prepared to show the prospective buyers, and • there was the presence of profit motive, and these facts represented characteristics of the nature of trade.

Accordingly, the dominant intention was *not* to live near St. Bridget's Convent to facilitate children's schooling. It was held the transaction was an adventure in the nature of trade and hence taxable.

(ii) **Repair and improvement cost**

Per the information provided, the company purchased the old building in 2018/19 with the intention to do a major repair in 2019/20 to bring it to a useable condition level. Accordingly at the time of purchase, that major repair was due and per Section 11 of the IRA it is an expenditure of capital nature (i.e. expense that secures a benefit capable of lasting longer than twelve months).

Further per Section 37,

The cost of an asset of a person shall be the sum of:

(a) expenditure incurred by the person in acquiring the asset including, where relevant, expenditure on construction, manufacture or production of the asset

(b) expenditure incurred by the person in altering, improving, maintaining or repairing the asset

(c) incidental expenditure incurred by the person in acquiring and realising the asset

Accordingly, the expenses incurred on renovating and modifying the building (which is a depreciable capital asset) to bring it to a useable condition as a cinema at the end of the year of assessment 2019/20 has to be capitalised as cost in 2019/20 and capital allowances can be claimed from Y/A 2019/20 onwards as the building is used for business from that year of assessment.

Per Low Shipping Co. Ltd VS CIR it was held that repairs deemed necessary at the time of purchase to render the subject matter of purchase usable, was a capital charge, which can be added to the initial cost, and cannot be deducted in computing profits and income. Per the case Theobald VS Commissioner of Income Tax it was held that any expenditure incurred that would result in an 'enduring benefit', is of capital nature.

(Total: 50 marks)

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