THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

No of pages: 12

Business Level

Business Taxation & Law

(Pilot Paper)

Instructions to candidates

(1) Time allowed: 3 hours

(2) **Section 1 – Business Law**

5 questions – **all questions are compulsory**

Section 2 - Business Taxation

2 questions – **both questions are compulsory**

(3) Answers to questions should be in the answer booklet provided to you. Begin each answer on a separate page.

(4) All answers should be in **English.**

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June 2015

Section 1 - Business Law

All questions are compulsory.
Total marks for Section 1: 50 marks.
Recommended time for the Section is 90 minutes.

A minimum score of 25 marks for this section is needed to pass the module

Question 01

Arvis, a film director, is in a hurry to incorporate a limited liability company in order to meet a tight time schedule for the production of his next film "Animals".

Arvis desires to be the only shareholder of this company.

He has already decided on a choice of names for this company. They are as follows:
- "Arvis Movies"
- "Ceylon Circus"

Xinta, a leading actress, is earmarked by Arvis to play the main actress's role in this film.

As time is of the essence in this matter, Arvis enters into a contract with Xinta in which Xinta agrees to play the lead actress's role.

Mr. No-it-All, a friend of Arvis's, after getting to know of these incidents, tells Arvis that ***"there is doubt about the legality of the following:***
- ***having only one shareholder in the company,***
- ***obtaining approval on the proposed company names,***
- ***the contract between Arvis and Xinta."***

Arvis seeks your **explanations** to clear the doubts expressed by Mr. No-it-All.

(Total 10 marks)

Question 02

Generous (Pvt) Ltd, was incorporated under the Companies Act No. 7 of 2007.

Its Articles of Association were framed in accordance with the Model Articles given in the First Schedule to the Act.

All shareholders of Generous (Pvt) Ltd are of one class, namely holders of ordinary shares with voting rights.

The board of directors of Generous (Pvt) Ltd, have proposed to declare a dividend distribution amounting to Rs. 5 Mn to all shareholders.

The board of directors seeks clarification on the steps it should adhere to in order to make this distribution in accordance with the provisions of the Companies Act No. 7 of 2007.

You are required to **explain** to the board of directors of Generous (Pvt) Ltd:

- The procedure the board should follow to declare this dividend, in accordance with the provisions of the Companies Act
- The liability of the directors, if the provisions of the Companies Act are not followed in making this distribution.

(10 marks)

Question 03

The board of directors of Compliance (Pvt) Ltd, is deliberating on whether to give its approval for the Company to undertake a mini hydro power project.

A team of professional engineers who are also employees of the Company, have prepared a feasibility report which concludes that this project is viable.

Further, the directors have proposed the re-appointment of Essell, as the auditor of the Company for the financial year 2015/2016.

Essell has requested an audit fee of Rs. 100,000 plus taxes plus direct re-imbursable expenses. The directors are in agreement with this.

You are required to:

(a) **Explain** whether the board can decide to undertake the mini hydro power project relying on the feasibility report mentioned above.

(5 marks)

(b) **Prepare** the resolution required under the Companies Act, in order to re-appoint Essell.

(5 marks)

(Total 10 marks)

Question 04

(a) Morris is engaged in a sole proprietorship business of importing and selling re-conditioned cars.

Due to changes in the tax regulations, his business has now become a high risk one for him, especially as he has many high value creditors.

Morris has heard that if he forms a private limited liability company, he can limit his liability in the business to the value of the shares he has invested in.

You are required to:

Explain to Morris the general features of a private limited liability company.

(5 marks)

(b) Zee (Pvt) Ltd is considering appointing an administrator to strike a compromise with its creditors, as per the provisions of the Companies Act.

They have two main contenders for the post of administrator.

One is Bee, the main creditor of Zee (Pvt) Ltd.

The other is Dee, a retired gentleman with an unblemished character.

You are required to :

Outline to the board of directors of Zee (Pvt) Ltd, which one of Bee and Dee would be advisable to appoint as the administrator of the Company, and the steps the board should follow in appointing the administrator.

(5 marks)

(Total 10 marks)

Question 05

(a) Amal, a professional accountancy student, is a keen reader of the newspaper "*My Business*".

One day it carried an article titled "*Alleged Insider Trading by Top Bureaucrat*", on which Amal wishes to seek some clarification.

This article stated that **"insider trading** refers to the trading of a public company's stock or other securities (such as bonds or stock options) by individuals with access to non-public information of the company."

It further stated that "there have been many **instances which fall within the above definition of insider trading**, which have been reported to the Securities of Exchange Commission (SEC) of Sri Lanka."

> You are required to:
>
> **Summarize** four (4) such instances.
>
> **(4 marks)**

(b) Yoyo entered into a contract with Jojo to construct an open air zoo in the hill country.

The contract agreement contained an arbitration clause which stated: "in the event of a dispute in relation to this contract, the parties shall resolve such dispute through the process of arbitration."

Subsequently, a dispute arose and as per the contract agreement the parties sought the help of arbitration to resolve this dispute.

After attending a few hearings, the Arbitration Tribunal informed the parties that "the arbitration award will be given at the next hearing date."

Yoyo, who is involved in an arbitration for the first time, seeks your counsel on a few concerns he has.

> You are required to:
>
> **Explain** to Yoyo the nature and effect of an arbitration award and how such an award can be enforced. **(6 marks)**
>
> **(Total 10 marks)**

Section 2- Business Taxation

> *Both questions are compulsory.*
> *Total marks for Section 1: 50 marks.*
> *Recommended time for the Section is 90 minutes.*
>
> *A minimum score of 25 marks for this section is needed to pass the module.*

Question 01

Printing Technology (Pvt) Ltd (PTPL) is a limited liability company incorporated in Sri Lanka in 1998 to manufacture printing materials for both export and domestic markets. 80% of the Company's stated capital at the end of the financial year is owned by its parent company Investments Holding Ltd (IHL).

PTPL has appointed you as a tax advisor and has provided you with the following information to compute its income tax liability for the year of assessment 2014/2015.

The accounts for the year ended 31/03/2015 disclosed a net profit of Rs. 27,500,000 before taxation after deducting administration, selling and distribution and financial expenses and after crediting a sum of Rs. 10,000,000 by way of other income.

Notes

1.0 Property, plant and equipment

1.1 The Company has capitalized the following assets during the year of assessment 2014/2015.

Machinery	Rs. 7,020,000
Van for transport of goods	Rs. 3,200,000
Land	Rs. 8,460,000
Stores building	Rs. 3,000,000

i. Machinery of Rs. 7,020,000 is comprised of high tech machinery acquired for energy efficiency purposes amounting to Rs. 3,000,000 and machinery imported on 01/10/2014 amounting to Rs. 4,020,000 for the purpose of replacement of machinery disposed of during the year of assessment.

ii. The van was obtained by the company under a finance lease arrangement from a finance company on 01/04/2014. The monthly lease rental payable under the agreement for a period of four years amounts to Rs. 100,000.

iii. The stores building was acquired from a person who had used such building for the same purpose i.e. as a storage facility.

iv. Unless otherwise indicated, it is assumed that except machinery imported on 01/10/2014, additions during the year represent the assets acquired/capitalized by the Company at the beginning of the year of assessment on 01/04/2014. The rates of depreciation per annum on are 12.5% on machinery, 20% on motor vehicles and 10% on the stores building.

1.2 The Company has claimed and received depreciation allowances in full for all the assets held as at 01/04/2014 except for the following.

- Factory building constructed in 2012/2013 at a cost of Rs. 12,800,000.
- Machinery acquired on 02.05.2012 for a sum of Rs. 3,000,000.

1.3 The Company has disposed of the following assets during the year of assessment 2014/2015.

Asset	Selling price (Rs.)	Date of purchase	Cost (Rs.)
Machinery	1,200,000	02/05/2012	3,000,000
Car	2,000,000	05/07/2011	4,200,000

Profits from these disposals have been accounted under other income.

2.0 Investment property

During the year of assessment the Company has disposed of a block of land of 15 perches situated in Ratmalana for a sum of Rs. 12,000,000. The Company had acquired this property in the year 2012 to construct a building to be used as a storage facility. As the new store building was acquired during the year, the Company has decided to dispose of this property. Profit of Rs. 2,100,000 from the disposal is accounted under other income.

3.0 Intangibles

Detail of intangibles acquired by the Company and the rates of amortization to the income statement are given below.

Asset	Year of acquisition	Cost (Rs.)	Rate of amortization
Patents	2013/2014	8,000,000	10%
Software	2013/2014	2,000,000	10%

Software represents acquisition of locally developed software of Rs. 800,000 and imported software of Rs. 1,200,000.

4.0 Turnover

The breakup of turnover is given below.

Exports – direct	Rs. 172,000,000
Exports – indirect	Rs. 20,000,000
Domestic market	Rs. 288,000,000

5.0 Other income

Other income consists of the following.

Profit from sale of land	Rs. 2,100,000
Profits from sale of property, plant and equipment	Rs. 520,000
Dividend received (net) – from local companies	Rs. 1,440,000
Interest income from Treasury bills	Rs. 1,962,000
Rent income	Rs. 2,400,000
Profits from sale of shares in listed companies	Rs. 1,578,000
	Rs. 10,000,000

6.0 Administration expenses

Administration expenses include the following.

- Research expenses of Rs. 2,400,000 for improving the quality of the product includes the cost of research carried out through a non-related company in Sri Lanka amounting to Rs. 1,000,000.
- Provision for gratuity of Rs. 1,700,000. The provision for gratuity account indicates balances of Rs. 10,400,000 and Rs. 9,300,000 as at 31.03.2014 and 31.03.2015 respectively.
- Cost of repairs of Rs. 2,800,000 includes the repair cost of Rs.720,000 incurred for premises given on rent.
- Management fee of Rs. 13,250,000 paid to the holding company.
- Donation of Rs. 1,300,000 includes donations in money of Rs. 500,000 to a Government hospital, Rs.100,000 to an approved charity (temple) and Rs. 600,000 to an approved charity established for the provision of institutionalized care for the sick.
- Depreciation charged on property, plant and equipment amounts to Rs.5,200,000

7.0 Selling and distribution expenses

Selling and distribution expenses include the following.

- Foreign travel expenses of Rs. 2,200,000 which includes expenses of Rs. 500,000 incurred for the purpose of export of goods. The rest of the foreign travel was for purposes of inspecting imported raw materials. Tax adjusted profit for the year of assessment 2013/2014 is estimated to be Rs. 7,800,000.

- Cost of advertisement of Rs. 4,750,000 which includes cost amounting to Rs. 400,000 incurred outside Sri Lanka for export promotion.

8.0 Financial expenses

Financial expenses include the following.

- Interest portion under the finance leasing arrangement of Rs. 600,000.
- Share issue expenses of Rs. 120,000.

9.0 Losses from trade

The Company has brought forward a tax adjusted loss from trade from the year of assessment 2013/2014 amounting to Rs. 28,450,000.

10.0 Payment of dividend

The Company has distributed a gross dividend of Rs. 8,000,000 to its shareholders on 27/09/ 2014 out of profits and income from the main operation for the year of assessment 2013/2014. The 5% of the stated capital for which dividends are paid represents the shares issued to a Unit Trust. Distributable profit for the year of assessment 2013/2014 is estimated to be Rs. 10,000,000.

Required:

1. Based on the above information, you as the tax advisor of the Company are required to:
   i. **Assess** the statutory income from trade for the year of assessment 2014/2015.
   (12 marks)
   ii. **Assess** total statutory income, assessable income and taxable income for the year of assessment 2014/2015.
   (4 marks)
   iii. **Assess** the total income tax liability (gross) of the Company for the year of assessment 2014/2015.
   (3 marks)
   iv. **Explain** to the Company the minimum amount of dividend to be distributed out of the distributable profits and the time frame for distribution for the year of assessment 2014/2015 in order to avoid tax on distributable profit for the year of assessment 2015/2016.
   (3 marks)
2. **Explain** to the finance director the planning of the tax on dividend distribution of this Company as he is highly concerned about the income tax liability on the distribution of dividend.
   (1 mark)

3.	**Explain** to the Company the impact on the tax computation where the proportion of direct exports is 80% of the total turnover. You are not required to quantify the tax impact. **(2 marks)** **Total 25 marks**

Question 02

Anthony and David are the partners in a partnership carrying on the business of providing consultancy services. The partnership is a registered person for VAT. Profit is shared between Anthony and David in the ratio of 60% and 40%. Total supply of the business excluding advance received is Rs. 151,375,000, the break-up of which is given below.

Export of services	Rs. 57,525,000
Supply of services to exporters	Rs. 15,350,000
Supply of services to the local market	Rs. 78,500,000
	Rs. 151,375,000

As the partnership supplies consultancy services to exporters, it has obtained registration as a registered identified supplier (RIS) from the Commissioner General of Inland Revenue. The partnership has made an effort to also obtain RIP status, but this has not yet been accorded since the total supply from zero rated and suspended supplies is less than 50% of the total supplies.

Further, the net profit of the partnership for the year ended 31/03/2015 amounts to Rs.47,500,000. The partnership has deducted following expenses in arriving at net profit. All export proceeds have been remitted to Sri Lanka through a bank.

Salary paid to partners	
Anthony	Rs. 3,600,000
David	Rs. 5,400,000
Ground rent paid for hiring a car park for clients	Rs. 900,000
Depreciation	Rs. 2,240,000
Rent paid on the premises to the partner – Anthony	Rs.1,200,000
Cost of construction of boundary wall surrounding the building	Rs. 300,000
Cost of entertainment for clients	Rs. 4,800,000

Even though the partnership has paid rent to other parties, it has collected rent in letting a premises to a third party and received an advance. Such advance which is net of VAT is Rs. 1,000,000.

The breakup of the depreciation expense is as follows.

Furniture acquired in October 2014 for Rs. 6,200,000	Rs. 1,240,000
Car acquired for travelling in December 2014 for Rs. 5,000,000	Rs. 1,000,000
	Rs. 2,240,000

NBT paid to customs on the above vehicle is Rs. 172,305.
Other than the above purchase, nothing has been purchased from VAT registered persons during the quarter ended 31st December 2014. The value of supplies made by the Company under the VAT Act for the quarter ended 31/12/2014 is given below. Assume that no input tax has to be claimed on invoices received in previous taxable periods, and all due credit vouchers have been received during the above taxable period.

Export of services	Rs. 9,750,000
Supply of services to exporters	Rs. 3,850,000
Supply of services to the local market - exclusive of VAT	Rs. 20,500,000

Required:

1. **Explain** the basis on which income tax is charged on a partnership.
(2 marks)
2. **Assess** the divisible profit of the partnership for the year of assessment 2014/2015.
(5 marks)
3. **Assess** the income tax liability of the partnership for the year of assessment 2014/2015.
(2 marks)
4. **Assess** the distribution of divisible profit and tax paid by the partnership among the partners.
(2 marks)
5. **Assess** the VAT liability for the quarter ended 31/12/2014.
(6 marks)
6. **Assess** the NBT liability for the quarter ended 31/12/2014.
(3 marks)
7. **Advise the partnership** giving reasons by reference to statutory provisions, on whether the partnership is required to furnish a return on Economic Service Charge.
(3 marks)
8. **Explain** to the partnership as to what information has to be submitted to the Department of Inland Revenue along with the return of income.
(2 marks)

(Total 25 marks)