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THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KB 3 – Business Taxation and Law

June 2015

SECTION 1 - Business Law

Answer 01

(a)

Relevant Learning Outcome/s: 1.3.4

1.3.4. Assess the situations where the “veil of incorporation” can be lifted, with reference to relevant cases.

Suggested Detail Answer:

Generally, the law considers the company as a separate legal personality from its shareholders, as was laid down in the decided case of *Salomon v. Salomon & Co.*

But in certain instances, the courts will disregard this separate legal personality of the company, and lift its “veil of incorporation”, in order to see the real persons controlling the company.

Eg: - *Littlewoods Mail Order Stores Ltd. v. Inland Revenue Commissioner.*

In the given scenario, it seems that Mr. Crooks the controlling shareholder of Charity (Pvt) Ltd. is trying to use the company as his agent, towards the furtherance of an unlawful activity of his (Mr. Crooks’).

Also it seems that Mr. Crooks is trying to abuse the company by getting it to perform an unlawful activity.

In such situations, the courts may, in all probability, lift the veil of incorporation

Further, the courts may hold Mr. Crooks, as the controlling shareholder, liable for this unlawful act envisaged to be committed through the company, and may issue an order preventing the commission of this act.

(6 marks)

(b)

Relevant Learning Outcome/s: 8.3.1.

8.3.1. Identify “arbitrability” disputes
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Suggested Detail Answer:

A clause of this nature is called an arbitration clause.

Such a clause places a mandatory obligation on the parties to the contract, to resolve any dispute that may arise on the contract, through the process of arbitration.

Further the arbitration clause, also lays down the procedure, which has to be followed by the parties in the case of a dispute. Eg : in this scenario, submit the dispute to a sole arbitrator for resolution.

Since both parties, at the time of entering into the contract, have opted to resolve any dispute that may arise out of the contract through arbitration and without the use of the formal court system, the arbitration clause operates as a bar to litigation.

Therefore a court of law will in all probability refuse to hear this dispute, due to this arbitration clause.

Therefore in the given scenario, Bear Brothers (Pvt) Ltd’s attempt to institute legal proceedings in a court of law to recover damages from Daughters & Sons (Pvt) Ltd., may not be successful.

(4 marks)

[Total = 10 marks]

Answer 02

Relevant Learning Outcome/s: 2.3.1

Analyse the rights and duties of promoters, including liability for pre-incorporation contracts, with reference to relevant cases.
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Suggested Detail Answer:

The facts relating to the transaction between Cyril and the company to be incorporated, LPL, falls within the scope of a pre-incorporation contract.

There is an implied warranty under the law relating to pre-incorporation contracts, that once incorporated, the company LPL will ratify this transaction.

As a result under general circumstances, LPL, can ratify and accept the transaction between Senevi and Cyril.

But in the given scenario, the Object Clause restricts the business activities of LPL, to the tea industry.

Therefore as per the ultra vires doctrine, any activity conducted by the company, outside the scope of the Object Clause, is deemed to be void in law.

But the Companies Act No. 7 of 2007, dispenses with the ultra vires rule.

Section 13 of the Companies Act grants a company the freedom to engage in business activities without being restricted to its Object Clause.

Section 17 of the Act, says that even if the company engages in activities outside the scope of its Object Clause, such activities shall not be affected by the restrictions imposed by the Object Clause.

This means that no act or contract entered into by a company shall be treated as invalid, by reason of such act or contract being done in contravention of the restriction in the Object Clause.

Hence in the given scenario, the contract to purchase a rubber factory is valid and cannot be set aside based on the restriction contained in the company's Object Clause.

Therefore the company, LPL, can ratify and adopt this transaction with Cyril.

(Total 10 marks)

Answer 03

(a)

Relevant Learning Outcome/s: 3.5.1

3.5.1 Compare and contrast rights available for shareholders and debenture holders.

Suggested Detail Answer:

The following are the main differences between an ordinary shareholder with voting rights and a debenture holder.

- A shareholder or member is a joint owner of the company; but a debenture-holder is only a creditor of the company.
- A shareholder has a voting right at a meeting of the company; whereas a debenture-holder has no such right.
- A shareholder is invited to attend the annual general meeting of the company; whilst a debenture-holder is not invited for annual general meetings, unless any decision affecting the debenture holder's interest is to be taken up at that meeting.
- Interest on debentures is payable whether there are profits or not. But dividend on shares is paid only when the company has earned a profit.
- The interest on debentures is paid on pre-determined fixed rates; whereas the dividends payable to a shareholder is not a fixed amount, but based on many factors.
- Interest on debentures may be paid out of the capital of the company; but dividend on shares can never be paid out of the company's capital.
- Debentures are generally secured and carry a charge on the assets of the company; whereas shares of a shareholder have no such charge attached to them.
- In the event of a winding up of the company, a debenture-holder being a secured creditor of the company, is re-paid his/her loan to the company, prior to a shareholder whose funds will be refunded only after all the other claims have been settled.
- A company can repay the debentures in accordance with the terms of issue; but (other than in the case of redeemable preference shares) the share capital cannot be repaid without adhering to legal formalities.
- Debentures can be issued at a discount; whereas shares cannot be issued at a discount.

[5 marks]

(b)

Shera owns 600 ordinary shares with voting rights, out of the 10,000 ordinary shares of the same class, issued by Captain Cool (Pvt) Ltd.

Though she owns these shares jointly with her husband, as per Section 226(3) of the Companies Act, both of them together will be treated and counted as a single shareholder, for the purposes of determining the criteria for an application to courts under Section 224 for oppression.

Therefore this amounts to Shera holding 6% of the total voting rights of the company as well as accounting for 6% of the total shares of the company.

Section 226(1) of the Companies Act, states that a shareholder should have at least 5% of the voting rights, or at least account for 5% of the total shareholders of a company, in order to be eligible to make an application to courts under Section 224 for oppression.

From the given facts of the scenario, Shera does have more than the minimum 5% mentioned above, and hence qualifies to make an application to courts under Section 224 for oppression, provided she had this 5% qualification for at least 6 months prior to making the application for oppression under Section 224.

[5 marks]

[Total 10 marks]

Answer 04

(a)

Relevant Learning Outcome/s: 5.1.2

5.1.2 Prepare a notice for an Annual General Meeting
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Suggested Detail Answer:

Notice of Meeting

NOTICE IS HEREBY GIVEN that the Annual General Meeting for the year 2014/2015 of Zombi (Pvt) Ltd, will be held on Saturday, 9th May 2015 at 9.00a.m. at No. 1, Sleepy Lane, Creepytown.

AGENDA

1. Approving the minutes of the last AGM held on 25th July 2014.
2. Presenting and approving the Audited Accounts for the Financial Year ended 31st March 2015 together with the reports attached thereto.
3. Approval for the Dividend proposed at the rate of Rs. 5per share.
4. Appointment of Auditors for the financial year 2015/16.
5. Any other business

By order of the Board

Company Secretary

On this 29th day of April 2015.

Note

A member who is entitled to attend and vote at the Meeting, is entitled to appoint a Proxy to attend and vote instead of him/her. A Form of Proxy accompanies this Notice.

Duly filled and signed Proxies should reach the registered address of the Company at No. 1, Sleepy Lane, Creepytown, on or before 7th May 2015.

(8 marks)

- (b) Oggy as the proxy holder enjoys the same rights as the shareholder unless his powers have been restricted. In the absence of anything to the contrary given in the scenario, he has a right to speak at the meeting and raise this query.

As per Section 135 of the Companies Act, the length of notice to be given for an AGM is 15 working days. Therefore it seems that in this instance the company ZPL has not given adequate notice.

But in such a situation, where the company has given a shorter notice, if all shareholders entitled to attend and vote at the AGM, agree to such short notice, then the AGM shall be deemed to be duly called.

(2 marks)

[Total 10 marks]

Answer 05

Relevant Learning Outcome/s: 6.1.1

6.1.1 Differentiate “compulsory and voluntary winding up” and explain their consequences.

Suggested Detail Answer:

(a)

Under Section 270 of the Companies Act No. 7 of 2007, a creditor can file a petition in the courts, to wind up a company, if it can be established that the company is unable to pay its debts.

In order to establish whether a company is unable to pay its debts, the following criteria should be satisfied as per Section 271:

- The debt should exceed Rs. 50,000/-, and,
- Three (3) weeks should have lapsed from the date of receipt of the letter of demand.

In the given scenario, the 1st criteria is present, but the 2nd criteria has not yet been fulfilled.

Therefore Ruthless cannot file a petition in a court of law immediately to wind up the company, but will have to wait for the 2nd criteria of 3 weeks to lapse, in order to file this petition.

(5 marks)

Relevant Learning Outcome/s: 7.1.4.

7.1.4. Explain “insider dealing” and relevant information.
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Suggested Detail Answer:

- (b) Sneeky, due to his professional relationship as the auditor of the company falls within the category of a person connected to the company or an “insider”.
- [Ref: Section 34].

As a result of being an “insider” in relation to the company, Sneeky has come to know of certain information in relation to the company, which is not yet available to the public.

When Sneeky passes this information to his brother Quicky, Quicky in turn falls within the category of an “insider”.

When Quicky makes use of this information to trade in the securities of the company and makes a profit from this transaction, he has gained an unfair advantage over other traders who are not privy to such information.

The Securities and Exchange Commission Act (SEC Act) expressly prohibits insiders like Quicky from trading in listed securities of a company. [Ref : Section 32]

Since Quicky has already traded in violation of the SEC Act as stated above, Quicky has committed the offence of “insider trading”, and is liable for punishment.

(5 marks)
[Total 10 marks]

SECTION 2 – Business Taxation

Answer 06

(a)

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

Suggested Detail Answer:

The computation of tax liability of Lucky Biscuit Manufacturers (Pvt) Limited for the year of assessment 2014/15

	Rs.`000	Rs.`000
Net profit	82,080	
Less		
Dividends – net		540
Interest from government securities		270
Fixed deposit interest net		360
Gross Rent received -part of the business income		
Profit from sale of a lorry		3,500,
Cancel the entry – book depreciation	3,000	
Tax Profit on the disposal of the lorry Sale price – (cost of acquisition - C/A granted) 3,500,000 -(3,800,000 - 3,800,000) = 3,500,000	3,500	
Office building – constructed 15,000,000 x 10% constructed		1,500
Factory building – 30,000,000 x 6 2/3% Purchased building used by the previous owner for a business		2,000
25% of the salary bill = 42,120,000 x 25% = 10,530,000 Contributions to approved funds are 12,257,000 which is more than 25% from the salary bill , therefore Rs. 1,727,000 is disallowed	1,727	
Cost of air tickets purchased for the business team– allowed subject to 2% of the statutory income of the previous y/a 16,900,000 x 2% = 338,000 354,000 – 338,000 = disallowed	16	
(i) Rent paid to the land lord = 900,000 (ii) Rent on value of the residence (200,000 +40,000) = 240,000 (iii) Higher of above (i) or (ii) = 900,000 (iv) Value of the benefit for the PAYE purpose = 180,000 (since employment income is more than 600,000) Rent paid - Rental value for the PAYE purpose 900,000 – 180,000 = 720,000 75% of 720,000 is disallowed	540	

Management fee paid 7,234,000 1% of the turnover or 3,460,000 Allowable amount 3,460,000 or 2,000,000 whichever is lower ,i.e 2,000,000 CGIR has allowed 60% of 7,234,000 = 4,340,000 4,340,400 or 2,000,000 whichever is higher . i.e = 4,340,000 is allowed	7,234	4,340
Advertisement cost - 830,000 -300,000 = 530,000 x25% disallowed 300,000 , capital allowance is available 300,000 x 10%	300 132.5	30
Ground rent - allowed		
Entertainment	658	
Donation	125	
Interest paid to its holding company [(30,000,000 + 4,600,000) x 3] = 103, 800,000 loan amount is 184,000,000 Disallowable interest $\frac{(184,000,000 - 103,800,000) \times 9,400,000}{184,000,000}$	4,097.5	
Statutory income from trade	103,410	12,540
		90,870
Add other sources of income Net Dividend received (does not form part of the statutory income)		
Treasury bill interest $\frac{270,000 \times 1 + 270,000}{9} = 300,000$		300
Fixed deposit interest $\frac{360,000 \times 100}{90}$		400
Total statutory income		91,570
Less: deduction under section 32		
Assessable income		91,570
Less qualifying payments		
Donation made to an approved charity which maintains sick and needy people, and subject to 1/5 th of assessable income of Rs. 500,000 which is lower		125
Taxable income		91,445
Tax liability 91,445 x 28%		25,605
dividends distribution 500,000 /10 * 100 5,000,000 x 10%	500	
Total tax liability		26,105
Tax credits Notional tax credit WHT credit Dividend tax credit SA payments	30 40 500 5,800	
Balance payable/refund		19,735

(b)

Relevant Learning Outcome/s:
2.1 – Dividend Tax
2.2 – Tax on deemed distribution

	Rs.'000
Net profit	82,080
Add: Notional loss	-
Book depreciation	<u>2,000</u>
	84,080
Less:	
Income tax payable	25,605
Cost of acquisition of a capital asset	<u>30,000</u>
Distributable profit	28,475
Amount to be distributed = $(28,475 \times 10\%)$	<u>2,848</u>
 Amount of dividend distributed	 5,000

Therefore no deemed dividend tax will arise.

(Total 25 marks)

Answer 07

(a)

Relevant Learning Outcome/s:
3.1. Partnerships
4.1. Returns on income and distributions
5.1. Value Added Tax (VAT)

Computation of Divisible profits of Aruna Brothers for the year of assessment 2014/15		
	Rs.	
	+	-
Net profit as per account	3,000,000	
Less: Interest income		180,000
Add: Salaries paid to Partners		
Aruna Rs. 1,200,000		
Varuna Rs. 1,200,000	2,400,000	
salaries paid to Aruna's wife – 1,200,000 allowed		
* Royalty paid to Aruna - Rs. 1,800,000 allowed		
Rent paid to Varuna - Rs. 600,000 allowed		
Rates and cost of repairs borne by the partnership - allowed		
Annuity – Disallowed Annuity paid to w/k of the partner is not deductible under section 32	600,000	
Book depreciation – Lathe machine	300,000	
Lathe machine –Capital Allowance Rs.3,000,000 @ 33 ¹ / ₃ %		1,000,000
Adjusted trade profit	5,120,000	
Deductions under section 5.76	<u>Nil</u>	
Divisible profit	<u>5,120,000</u>	

Note: Interest income will not be part of the other income of the partnership as WHT has been deducted at source.

Computation of Partnership tax

$$\{ [\text{Divisible profit} + \text{other income}] - 1,000,000 \} \times 8\% \\ \{ 5,120,000 + 0 \} - 1,000,000 = 4,120,000 \times 8\% = 329,600$$

Distribution of profits among the Partners

	Total	Aruna	Varuna
Share of profit	2,720,000	1,360,000	1,360,000
salaries paid to partners	2,400,000	1,200,000	1,200,000
Divisible profit	5,120,000		

- (b) A partnership business is not required to furnish audited financial statements unless it has a turnover in excess of Rs. 50,000,000 for a Y/A from its business or a divisible profit in excess of Rs. 25,000,000 for a Y/A. According to the information available neither, turnover or the divisible profit of the partnership carried out by Anura and Varuna has exceeded the above limits and therefore they are not required to submit audited accounts together with their partnership tax return. However partnership has to submit audited statement of accounts if an assessor has requested such accounts.

- (c) Computation of VAT Payable for the taxable period 01/01/2015 to 31/03/2015

Supplies at Standard Rate	Rs. 6,000,000 @11%	Rs. 660,000
Suspended VAT	Rs. 3,000,000 @11%	<u>Rs. 330,000</u>
Total Output Tax		Rs. 990,000
Less: Input Tax		
Input tax on Local Purchase	Rs. 80,000	
Input tax on Imports	Rs. 120,000	
Total Input Tax	Rs. 200,000	
Input Tax B/F	Rs. 120,000	<u>Rs. 320,000</u>
VAT Payable for the quarter		Rs. 670,000
Less: SVAT Credit Vouchers		<u>Rs. 330,000</u>
Balance VAT Payable		Rs. 340,000

- (d) The following criteria need to be met to register as an RIP under the SVAT scheme.

The partnership should have suspended supplies exceeding 50% of the total supplies. Therefore, it should make supplies to persons who have been accorded RIP status under the suspended scheme.

(Total: 25 marks)

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