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THE INSTITUTE OF  
**CHARTERED** ACCOUNTANTS  
OF SRI LANKA

# **SUGGESTED SOLUTIONS**

**KE3-Fundamentals of Taxation & Law**

**March 2016**

# Part A

## Taxation

### SECTION 01

#### Answer 01

1.1

Learning Outcome/s: 1.1.2.

**Correct Answer A**

1.2

Learning Outcome/s: 3.1.3

**Correct Answer C**

1.3

Learning Outcome/s: 4.1.1

**Correct Answer D**

1.4

Learning Outcome/s: 4.2.2

**Correct Answer B**

1.5

Learning Outcome/s: 5.2.3

**Correct Answer D**

## Answer 02

2.1

Learning Outcome/s: 2.1.2	
Within the meaning of the Inland Revenue Act, in addition to an individual it includes a company, body of person or any government.	

2.2

Learning Outcome/s: 3.1.2	
Income from Trade	1,800,000
Interest Income – Gross (45,000/90*100)	<u>50,000</u>
Total Statutory Income	<u>1,850,000</u>
<u>Dividends received – does not form part of the Statutory Income</u>	

2.3

Learning Outcome/s: 3.1.4	
Tax on taxable income	456,000 x 12% = 54,720
Tax on dividend distributed	100,000 x 10% = <u>10,000</u>
	<u>64,720</u>

2.4

Learning Outcome/s: 4.4.3	
<ul style="list-style-type: none"><li>Excess tax paid can be claimed as a refund ,<ul style="list-style-type: none"><li>(i) by the return itself, or</li></ul>Within three years from the end of the year of assessment.<ul style="list-style-type: none"><li>(ii) by submitting an amendment return or</li><li>(iii) by separate request in writing</li></ul></li></ul>	

2.5

Learning Outcome/s: 5.1.2		
Output tax	234,000,000 x 11%	25,740,000
Input Tax		
On local supplies	10,545,000	
On Motor car	<u>( 327,000)</u>	
		<u>(10,218,000)</u>
<b>VAT Payable</b>		<b><u>15,522,000</u></b>

## SECTION 2

### Answer 03

Relevant Learning Outcome/s:
2.2 Statutory income from 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

<b>Gomes</b>			
<b>Computation of Income Tax Liability</b>			
<b>For the Year of Assessment 2014/15</b>			
		Rs.	Rs.
<b><i>Employment Income</i></b>			
Gross Salary	165,000 x 12	1,980,000	
Bonus received during the Y/A 2014/15		200,000	
Vehicle Allowance -Exempted up to 50,000	540,000 <u>600,000</u>	Exempt	
Employers contribution to Provident Fund		Not Taxable	
Income as Bank Employee			2,180,000
<b><i>Director's Fee</i></b>			
If total monthly remuneration is above Rs. 25,000/- tax rate will be 16%			
Net fees		630,000	
Tax deducted at 16%	630,000/84*16	<u>120,000</u>	
Gross fees		<u>750,000</u>	<u>750,000</u>
Total Employment Income			<u>2,930,000</u>
<b><i>Income from Property</i></b>			
<u>Rented House</u>			
Gross Rent	80,000 x 8	640,000	
Rates paid	24,000x8/12	<u>(16,000)</u>	
25% Repair Allowance		624,000	
Net Rent		<u>(156,000)</u>	
		<u>468,000</u>	
Net Annual Value			
Rating Assessment	120,000		
25% Repair Allowances	<u>30,000</u>		
Net Annual Value	<u>90,000</u>		
NAV for 8 months 90,000x 8/12 is 60,000			
<b>Since Net Rent &gt; NAV</b>			
Rent Income = Net Rent			468,000
NAV for 4 months 90,000			
	<u>(60,000)</u>		
	<u>30,000</u>		

<b>NAV 4 months(occupied by him)</b>		30,000	
<b>NAV of house occupied by parents</b>		<u>42,000</u>	
		72,000	
<b><u>NAV of one house is exempt from income tax.</u></b>			
Since the higher NAV is relating to the house occupied by parents, it has been <u>selected</u> for exemption		<u>(42,000)</u>	30,000
<b>Profit from business</b>	Note 1		712,940
<b>Dividend-</b> does not form part of the statutory income			
Profit from sale of shares exempt			
Salary paid to wife			145,000
<b>Total Statutory Income</b>			<b>4,285,940</b>
Less: <u>Deductions under Section 32</u>			
Interest paid on housing loan			235,000
<b>Assessable Income</b>			<b>4,050,940</b>
Less : Tax Free Allowance			(500,000)
Less: Qualifying payments On Employment Income		100,000	
Repayment of capital Since he is a professional and exercising duties as a professional Maximum claim limited to	750,000		
		600,000	
Life Insurance premium	54,000		
Donation to approved charity	25,000		
1/3 of the Assessable income or 75,000 whichever is lower Limited to Rs. 75,000	<u>79,000</u>	75,000	(775,000)
<b>Taxable Income</b>			<b>2,775,940</b>

<b>Computation of Income tax liability</b>			
On First 500,000/-	@ 4%	20,000	
On Next 500,000/-	@ 8%	40,000	
On Next 500,000/-	@12%	60,000	
On Next 500,000/-	@16%	80,000	
Balance 775,940/- (max tax rate on employment income of a 'Professional' is 16%)	<b>@16%</b>	124,150	324,150
Less:			
Self-Assessment tax paid for the year			25,000
PAYE Tax paid			75,000
WHT deducted on Director's fee			120,000
<b>Balance tax payable</b>			<b>104,150</b>

**Note 1 – Adjusted Profits from Business**

	(+)	(-)
Profit before tax as per accounts	589,510	
Depreciation – Furniture & Fittings	47,890	
Depreciation – Computer Equipment	25,650	
Cap. Allowances – Furniture & Fittings –Fully Claimed		
Cap. Allowance –Computer Equipment - Fully Claimed		
VAT paid on Rent – allowed for non-registered person		
Advertising 25 % of Rs.10,000	2,500	
Salary paid to wife-allowed		
Lease Interest	17,400	
Stamp Duty on lease	1,740	
Insurance – personal expenses disallowed	12,600	
Donation to Dansala	15,000	
Penalty for EPF	650	
<b>Adjusted profit from trade</b>	<b>712,940</b>	

**(20 marks)**

## Part B

### Legal Fundamentals

#### SECTION 01

##### Answer 04

4.1

Relevant Learning Outcome/s: - 1.4.1

**Correct Answer: B**

The rest of the legislative enactments are not applicable.

4.2

Relevant Learning Outcome/s: - 4.1.1

**Correct Answer: C**

This is correct, as the drawee signing on the bill is a mandatory requirement for accepting a bill.

4.3

Relevant Learning Outcome/s: 3.3.1

**Correct Answer: A**

This statement is incorrect, as the property in the goods will pass to the buyer at the time the contract is made.

4.4

Relevant Learning Outcome/s 8.2.1

**Correct Answer: D**

All the other offences are listed in the Act.

4.5

Relevant Learning Outcome/s: 6.3

**Correct Answer : B**

The lessor can recover possession without obtaining a court order. The procedure of which is detailed in the Act.

**(2 x 5= total 10 marks)**

## Answer 05

### 5.1

Relevant Learning Outcome/s: 1.2.1

- (i) Generally in a civil case, the person who files the complaint is called a plaintiff, and the person being sued is called the defendant. This is applicable in a case, which follows the regular procedure as per the Civil Procedure Code.

But there can be specific instances, such as in a summary procedure under the Civil Procedure Code, where the plaintiff is known as the petitioner; and the defendant is known as the respondent.

- (ii) The burden of proving the case of the plaintiff, is based on the “balance of probability”.

### 5.2

Relevant Learning Outcome/s: 2.6.1

In relation to initiating an action against a breach of a written contract, the Prescription Ordinance lays down a time frame of six years from the date of the breach occurring within which the aggrieved party, can initiate legal action.

But if the aggrieved party does not do so within 6 years of the date of the breach occurring, then he will have no further recourse in the eyes of the law for relief against that particular breach.

### 5.3

Relevant Learning Outcome/s: 8.1.1

The following are the main defenses available for

- (a) Contributory negligence –  
This is where the plaintiff too is at fault due to his own negligence.
- (b) Voluntary assumption of risk –  
This is where the plaintiff knowing the risk involved made a choice to assume the risk.
- (c) Inevitable accident –  
This is when the loss results due to an unavoidable accident.
- (d) Illegality –  
This means that the initial act which caused the injury was illegal, and hence no cause of action can result from an illegal act.



5.4

Relevant Learning Outcome/s: 9.1.1

The main types of LCs that are used in international trade are as follows :

- (a) Revocable and unconfirmed letter of credit.
- (b) Irrevocable and unconfirmed letter of credit.
- (c) Irrevocable and confirmed letter of credit.
- (d) Transferable letter of credit.

5.5

Relevant Learning Outcome/s: 3.4.1

A buyer has the following remedies, against a seller who has breached the contract for the sale of goods:

- (a) To initiate action for damages for non-delivery of goods, when the seller has failed to deliver the goods.
- (b) To initiate action in courts, for the specific performance of the contract of sale of goods.
- (c) To initiate action for the recovery of the price of the goods he has already paid the seller, in the event the seller has not delivered the goods to him.
- (d) To initiate action against the seller, for damages for the breach of a warranty in the contract of sale.
- (e) To initiate action against the seller, for damages for the breach of a condition in the contract of sale.

**(4 x 5= total 20 marks)**

## Answer 06

Relevant Learning Outcome/s: 2.2.2

### Part (a)

The given scenario falls within a contract made under a mistake.

In the scenario, both Pravin and Marker, made a mutual mistake, as to the identity of the subject matter of the contract which was the ship "Lanka Rani".

As a result no valid contract was formed between Pravin and Markar.

Hence the contract entered into by and between Pravin and Marker, becomes null and void in law.

The facts of the scenario are similar to the facts of the decided case **Raffles vs Wickelhaus** (1864) 2 H and C 906.

**(5 marks)**

### Part (b)

In the given scenario, one party to the contract, Pravin, enters into the contract on the genuine mistaken belief that he is entering into a contract of a totally different nature.

As Pravin was not negligent in making the endorsement, this contract is not binding on him, and hence is void.

Therefore Pravin is not liable for the endorsement he made on this bill of exchange.

The facts and decision given in the scenario, are similar to the decided case of **Foster vs Mackinnon** (1869) L.R.4 p. 704

**(5 marks)**

**(Total 10 marks)**

## SECTION 2

### Answer 07

Relevant Learning Outcome/s: 3.3.1

#### Part (a)

The Sale of Goods (SOG) Ordinance applies to the sale of movable goods. (2 marks) As land is immovable, the ordinance cannot be applied for the sale of a land (1 mark). Therefore, the question of Kamal bidding or not bidding for his own land, under the Sale of Goods Ordinance is not applicable in this instance (2 mark).

**(5 marks)**

#### Alternatively,

The scenario is relating to the sale of a land by an auction, and the question specifically refers to the Sale of Goods (SOG) Ordinance. However “land” does not fall within the definition of “goods” in the Sale of Goods Ordinance.

[But as the study text does not contain the definition of “goods”, it seems unfair to expect the students to distinguish whether land falls within the meaning of “goods” as per the SOG Ordinance. Therefore if a student assuming that land is also “goods”, has answered correctly, the point whether Kamal can or cannot bid for his own asset, by referring to the rules relating to a “sale by auction” as per the SOG Ordinance, full marks will be given. The suggested answer in that context would be as follows:]

As per the Sale of Goods Ordinance, in a sale by auction the following rules apply :

Unless the seller has given prior notice that he also has a right to bid at the auction, he cannot bid for his own goods.

In the given scenario, there is no evidence to suggest that Kamal has given prior notice of his intention to bid for his land.

Therefore in such a situation, the objection made by Channa and David will be upheld and Kamal will be prevented from bidding for his own land at this auction.

But on the contrary if there is evidence to show that Kamal has given prior notice of his intention to bid for his own land at this auction, then he cannot be prevented from making a bid. Hence, Channa and David’s objection will be rejected.

**(5 marks)**

**Part (b)**

For Ruwani to be identified as a “holder in due course” under the Bills of Exchange Ordinance (BOE Ordinance), she has to fall within the definition of a “holder in due course”.

The definition as per the BOE Ordinance is that, “a holder who has taken a bill, complete and regular on the face of it, before it was overdue, and without notice that it had been previously dishonored (if such was a fact), and in good faith and for fair value and without notice, at the time the bill was negotiated, of any defect in the title of the person who negotiated it.”

As per the given facts of the scenario, it could be said as follows :

- The cheque given to Ruwani seemed complete and regular on the face of it.
- There was no indication that it had been previously dishonoured.
- Ruwani deposited the cheque to her bank account, before it had become overdue.
- Ruwani was not aware of any defect in the title of Samanthi to the cheque, before the cheque was given to her.

Therefore from the given facts it could be said reasonably that Ruwani does fall within the definition of a “holder in due course”.

**(5 marks)**

## Answer 08

Relevant Learning Outcome/s: - 5.1.1

### Part (a)

As per the law of Agency, an agency can be created by necessity.

But the following conditions should be satisfied before an “agency by necessity” is created –

- (a) It must be impossible to get the principal’s instructions;
- (b) There must be an actual and definite commercial necessity for the creation of the agency;
- (c) The agent must act in good faith on the interests of all parties

In this scenario the transport company could have easily communicated with Herman as soon as the lorry arrived in Colombo and asked for his instructions on what to do about these vegetables.

But as the transport company did not try to even contact Herman, the first requirement for an agency by necessity (as stated above), has not been complied with.

Therefore even if the other 2 requirements are deemed to have been fulfilled, an agency by necessity has not been created in this instance.

Therefore in the given scenario the transport company is liable to pay damages to Herman. as no agency by necessity has been created.

The facts are similar to the case of **Springer vs G.W.Ry.** (1921) 1 K.B. 257, where a Railway Company was made liable to pay damages to the sender as no agency by necessity was created.

**(5 marks)**

**Part (b)**

Nimal and Nimalee can use any of the following methods to dissolve their partnership without referring to such dissolution to a court of law.

- (A) Upon the Expiration of the Term or by giving Notice of Termination, Subject to any agreement between the partners, Nimal and Nimalee, they can dissolve their partnership upon the happening of any of the events given below :
- (i) If the partnership is entered into for a fixed term, by the expiration of that term.
  - (ii) If the partnership is entered into for a single adventure or undertaking, by the termination of that adventure or undertaking.
  - (iii) If the partnership is entered into for an undefined time, by any partner giving notice of dissolution to the others.
- (B) Charge :  
If one partner suffers his share to be charged for a separate debt of his, the other partner may dissolve the partnership.
- (C) Illegality :  
If an event happens which makes it unlawful for the business of the firm to be carried on, the partnership is dissolved.

**(5 marks)**

**(Total 10 marks)**

## Answer 09

### Part (a)

Relevant Learning Outcome/s: 6.1.2

A fire insurance policy covers losses caused by fire.

For a fire to be treated as a “fire” under a fire insurance policy, there should be an ignition. In the given scenario ignition is present.

Therefore the type of fire which caused the damage to Kanchana’s jewellery, is a fire covered under fire insurance.

Further this ignition was not caused deliberately, by Kanchana, with the intention of destroying the jewellery.

Any loss by a fire, even a loss which is caused by the insured’s negligence is covered under this type of policy.

Therefore in conclusion it could be said that Kanchana could recover the damages from the Tintan Insurance Company (Pvt) Ltd., under her fire insurance policy.

Similar facts were discussed in the decided case of Harris v Poland (1941) 1 KB 462.

**(5 marks)**

### Part (b)

Relevant Learning Outcome/s: 7.2.1

(i)

As per Part II of the Payment of Gratuity Act, No. 12 of 1983, the following criteria should be satisfied for Jamis to be entitled for gratuity.

- The employer of Jamis, has to have 15 or more workmen, or should have employed 15 or more on any day during the period of 12 months immediately proceeding the termination of services of a workman.
- Jamis should have completed not less than 5 years of service under that particular employer.

(ii)

Jamis’s gratuity entitlement is calculated on the following basis:

As Jamis is a monthly salaried employee, his gratuity entitlement would be as follows :

GRATUITY

=  $\frac{1}{2} \times (\text{salary drawn for last month of employment}) \times \text{no. of completed years of service}$

=  $\frac{1}{2} * 30,000 * 6$

= Rs. 90,000

**(5 marks)**

**(Total 10 marks)**

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