SUGGESTED SOLUTIONS

KB3 - Business Taxation and Law

December 2016

SECTION 1

BUSINESS LAW

Answer 01

Relevant Learning Outcome/s:
1.3.3 Explain the concept of the 'veil of incorporation'. 1.3.4 Assess the situations where the 'veil of incorporation' can be lifted with relevant cases.

(a)

(i) The corporate veil is a legal concept that separates the personality of a company from the personalities of its shareholders, and protects them from being personally liable for the company's debts and other obligations.

This concept was established in the landmark case judgment of *Salomon v Salomon Co. Ltd.,* which held that the legal personality of a company is a veil or mask that covers the identity of its shareholders.

(ii) The courts have however been known to lift the corporate veil in the following instances:

- when the company has been used as a cover for deliberate wrong doing;
- when the number of members falls below the statutory minimum;
- to prevent a fraud from being perpetuated;
- to prevent deliberate evasion of contractual obligations;
- to promote the interests of national security, or to ensure conformity with public policy;
- if the controlling shareholder uses the company as his agent, or if the corporate body is abused for an unlawful or improper purpose;
- to determine the company's place of residence for the application of specific statues such as tax laws;
- where legislation provides for it.

(1 mark per point, maximum of 3 marks)

(b)

Relevant Learning Outcome/s:
6.1.1 Differentiate "compulsory and voluntary winding up" and explain their consequences. 6.2.1 Outline the functions of administrator/liquidator and receivers/managers

Section 272 gives a creditor the right to submit a petition to courts to wind up a company. Therefore as a creditor of Dunstan (Pvt) Ltd, Zimbo has a right to submit a petition to courts under Section 272 to wind up the company.

As per the given facts, the following grounds may apply to Zimbo, in supporting this petition in courts:

- The company has suspended its business from 30 June 2014 and has not recommenced even as at this date. This means that the company has suspended its operations for more than 1 year. Under Section 270(b), this becomes a ground for Zimbo to submit a petition to courts to wind up the company

- As per Section 271(a), the following can be applied to this scenario:
  - Zimbo is a creditor over the prescribed limit of Rs. 50,000.
  - Therefore, he must first serve a notice on the company at its registered office, demanding the company to settle his dues.
  - If the company does not settle within 3 weeks from the date of Zimbo leaving such notice then the company is deemed to be unable to pay its debts

  Therefore, in such a situation a ground arises under Section 270 (e) for Zimbo to make a petition to courts to wind up the company

(Total: 10 marks)

Answer 02

(a)

Relevant Learning Outcome/s:
2.4.1 Explain the contents and amendments to the Articles of Association.

Section 15 of the Act lays down the provisions on how a company can adopt the model articles as its own.

As due notice of the EGM has been given, we can safely assume that all provisions in relation to the notice of the EGM and the special resolution giving the text of the new articles have been duly complied with by the company.

At the EGM, the company has to pass the special resolution to adopt the model articles as its own articles.

Once the resolution is passed, the company must give notice of such resolution to the Registrar of Companies within ten working days setting out in full the text of the resolution and of the newly adopted articles of the company.

[Ref: Sect 15(2)]

(b)

Relevant Learning Outcome/s:
2.3.1 Analyse the rights and duties of promoters, including liability for pre-incorporation contracts, with relevant cases.

The scenario given relates to a pre-incorporation contract**.**

In situations prior the Companies Act No. 07 of 2007 coming into effect, the law relating to pre-incorporation contracts was laid down in the case of *Kelner v Baxter* [1866] L.R.2 CP 174.

<u>Alternatively, 1 mark to be awarded if the details or the ruling of the case were given as follows</u>

The argument of the plaintiff was that the liability under the contract had passed, by ratification, to the company.
[Ref: *Kelner v Baxter* [1866] L.R.2 CP 174.]

However, it was held that as the company did not exist at the time of the agreement, the contract would be wholly inoperative unless it was binding on the promoters personally and a stranger cannot by subsequent ratification relieve them from that responsibility.

Therefore the law prior to the Companies Act No. 07 of 2007 was that, pre-incorporation contracts were not recognised by the law. Hence, the promoters were held personally liable on these contracts.

However, after the Companies Act No. 07 of 2007 came into effect, the law relating to pre-incorporation contracts was laid down differently. As per Section 23 of the Act, the contract given in the scenario falls within the definition of a pre-incorporation contract.

Section 24 of the Act, says that where a person enters into a pre-incorporation contract for and on behalf of a company, that person is deemed to give an implied warranty that,

- The company will be incorporated within such period as may be specified in the contract, or if no period is specified, within a reasonable time after the making of the contract; and

- The company will ratify the contract within such period as may be specified in the contract or if no period is specified, within a reasonable time after the incorporation of such company.

Therefore under the Companies Act No. 07 of 2007, the company becomes liable for the pre-incorporation contracts entered into on its behalf by its promoters.

(Total: 10 marks)

Answer 03

(a)

Relevant Learning Outcome/s:
3.2.1 Explain the procedure for payment of dividends including that of a listed company.

Dividends fall within the meaning of a distribution under the Act.

As per the Model Articles, the provisions relating to the payment of dividends are as follows.

- The dividend or the distribution must be first approved by the directors of the company, and thereafter by an ordinary resolution of the shareholders.
- The directors must be satisfied that the company will immediately after the distribution of the dividend, satisfy the solvency test.
- The directors who vote in favour of this distribution must sign a certificate of their opinion to that effect.

[Ref: Sec. 56] – Therefore, in order to make a dividend payment, Heal Me PLC must follow the above procedure.

(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.

An executive director is a director of the company**,** who in addition to being a director has separate responsibilities within the company as an employee.

A managing director is an executive director who has been appointed by the board as the managing director of the company**.** Provided the articles of the company require otherwise, the managing director is generally an employee of the company as well.

A shadow director is a person under whose instructions the company operates, even though he is not a designated director of the company.

(Total: 10 marks)

Answer 04

(a)

Relevant Learning Outcome/s:
5.3.1 List company records, stipulated in the Company's Act.

Under the provisions of Section 116 of the Companies Act, a company is required to keep the following documents at its registered office.

(a) The certificate of incorporation and the articles of the company;

(b) Minutes of all meetings and resolutions of shareholders passed within the preceding ten years;

(c) An interest register, unless it is a private company, which is dispensed with the need to maintain such a register;

(d) Minutes of all meetings held and resolutions passed by the board of directors and directors' committees held within the preceding ten years;

(e) Certificates required to be given by the directors under the Act within the preceding ten years;

(f) The register of directors and secretaries as specified in Section 223;

(g) Copies of all written communications to all shareholders or all holders of the same class of shares during the preceding ten years, including annual reports prepared under Section 166;

(h) Copies of all financial statements and group financial statements required to be completed under the Act for the preceding ten completed accounting periods of the company;

(i) The copies of instruments creating or evidencing charges and the register of charges required to be kept under Sections 109 and 110;

(j) The share register required to be maintained under Section 123; and

(k) The accounting records required to be maintained under Section 148 for the current accounting period and for the preceding ten completed accounting periods of the company.

(b)

Relevant Learning Outcome/s:
3.5.2 The principles relating to "majority rule" and "minority protection" (including "Oppression, mismanagement and derivative action and Major Transactions) (S.185 of the Companies Act)

(i) The value of the total assets of the company

= Total non-current assets + Total current assets

= 200,000 + 100,000

= Rs. 300,000

Half the total assets = Rs. 150,000

Value of the proposed loan = Rs. 175,000

As the value of the proposed liability is more than half the value of the total assets the proposed transaction (obtaining a loan) falls within the scope of a major transaction under Section 185(2) (c) of the Act.

(ii) Section 185(1) of the Act gives instances where a company can validly enter into a major transaction.

Therefore in the given scenario, Tasty Tea (Pvt) Ltd can enter into the major transaction of obtaining a loan of Rs. 175,000 from Colombo Bank PLC in the following manner:

- by passing a special resolution or;
- contingent on approval by a special resolution or
- by obtaining the consent of all the shareholders to enter into this transaction: or
- by ensuring the company's articles expressly authorise the company to enter into this transaction

(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.

The objectives of regulating the securities market are as follows:

- to help the stock market operate more efficiently so that it can contribute to the increase in the overall wealth of the society

- to discourage dishonesty and encourage those who adopt or wish to adopt high standards to do so

- to encourage honest traders to realise that they do not need to adopt dishonest practices to compete with the dishonest by pushing such practices

- to promote professional competence and integrity among personnel in the securities market.

(b)

Relevant Learning Outcome/s:
8.3.4 Explain enforcement of the Arbitral Award.

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.

The High Court shall, on a day notified to the parties, proceed to file the award and give judgment in accordance with the award.

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

(Total: 10 marks)

SECTION 1

BUSINESS TAXATION

Answer 06

(a)

Relevant Learning Outcome/s:
1.2 Taxable income of a company
1.3 Gross income tax and balance tax payable
2.2 Tax on deemed distributions

MDH (Pvt) Ltd

Income tax computation for the year of assessment 2015/16

	Rs.	**Rs.**
Adjusted profit from trade or business (Note 1)		63,696,500
Add: Other sources income		
Dividend received → does not form part of statutory income		-
Fixed deposit interest (gross) = 1,800,000/90 * 100		2,000,000
Total statutory income		**65,696,500**
Less: Deductions under Section 32		
Interest paid for acquisition of the apartment → not deductible since this expenditure is not considered as interest itself		
Assessable income		**65,696,500**
Less: Qualifying payments		
Donation made to an approved charity ($^1/_5$ of the assessable income or Rs. 500,000, whichever is lower)		(100,000)
Taxable income		**65,596,500**
Tax liability at 28%		18,367,020
Dividend distribution = 10,000,000 x 10%		1,000,000
Total tax liability		**19,367,020**
Tax credits:		
WHT credit	200,000	
Dividends tax credit	1,000,000	
Self-assessment payment	11,000,000	12,200,000
Balance payable/refund		**7,167,020**

NOTE 1

	Rs.	Rs.
	+	-
Net profit	51,050,000	
Less:		
Profit from the sale of a land → not chargeable to tax since it is a capital gain		3,830,000
Dividend received from companies (net)		1,300,000
Interest from fixed deposit (net)		1,800,000
Gross rent received – part of the business income		
Research and development		
Market surveys – disallowable	2,231,000	
R&D cost (6,652,000 – 1,400,000)	5,252,000	
R&D expenses, 200% is allowed (since the research has been carried out by the company itself) (6,652,000 * 200%)		13,304,000
Intangible asset		
Amortised from the lump sum payment – disallowed	1,000,000	
Allowed amount (5,000,000 x 10%)		500,000
Royalty - 2% of the turnover (768,000,000 x 2%)	15,360,000	
Paid amount (15,360,000 x 50%)		7,680,000
Expenses relating to building on rent		
Repair expenditure relating to the building given on rent → only 25% of the gross rent is allowable (6,000,000 x 25% = 1,500,000)		
Hence disallowed repair expenditure (1,750,000 – 1,500,000)	250,000	
Rates are allowed		
Investment property		
Interest paid on the purchase of the apartment (employment income of the MD is more than 1,800,000. This is disallowed under Section 26(1)(o)) (878,000 – 180,000) x 75%	523,500	
No capital allowance is available for this building as it does not fall into the category of a "qualified building"		
Cancel the book depreciation charge	16,000,000	
Capital allowance (Note 2)		800,000
Motor bicycles for executives → not allowed		
Penalty on non-payment of contribution on time	236,000	
Purchase of new tools not allowed because it is not a renewal	78,000	
Reimbursement of entertainment expenses	632,000	
Donation to an approved charity	100,000	
Paper notice → disallowed as the nature of expenditure is capital	63,000	
The total advertising cost = 3,263,000 – 63,000 = 3,200,000. Disallow 25% → 3,200,000 x 25%	800,000	

Lease		
Lease interest	462,000	
(i) $^{1}/_{5}$ the of lease value (6,762,000/5) = 1,352,400		
(ii) 6,762,000/48 * 8 = 1,127,000		
Allowable amount is the lower of the above two values		1,127,000
	94,037,500	**30,341,000**
Statutory income from trade		**63,696,500**

Note 02 – calculation of capital allowances

Item description	**Cost**	**Rate (%)**	**D/A**	
Capital allowance for the building transferred from the partnership, allowed on the tax written down value (12,000,000/15 * 7 = 5,600,000). Tax written down value is 6,400,000. As per Section 25(7)(f)(iii) available no. of years of assessment is 8. Therefore 6,400,000/8 = 800,000	6,400,000		800,000	
Machinery – capital allowance is available on the tax written down value 49,200,000/8 * 5 = 30,750,000. Tax written down value is 18,450,000. Available no. of years of assessment is only 3 years from 2011/12 onwards. Now the period is over.	18,450,000		-	
Lab equipment of Rs. 1,400,000 – since 200% has been claimed under research and development expenses, no allowance is due.			-	
Even though the previous owner has used it for his business as the head office, the new owner, (i.e. the company) has not used it as an industry building, but given it on rent instead. Therefore, capital allowance is not available.	120,000,000	6.67%		
			800,000	

(22 marks)

Computation of deemed dividend tax liability for Y/A 2015/16		
Net profit for the year of assessment 2015/16		51,050,000
Add: Book depreciation		700,000
		51,750,000
Cost of acquisition of capital assets	1,400,000	
Income tax payable for Y/A 2015/16	18,367,020	(19,767,020)
Distributable profit		31,982,980
10% of distributable profit		3,198,298
Since the distributed amount is more than 3,198,298 there will not be a deemed dividend tax liability		

(3 marks)

(Total: 25 marks)

Answer 07

Relevant Learning Outcome/s:
5.2 Nation Building Tax (NBT) 5.3 Economic Service Charge (ESC) 3.1 Partnerships 4.1 Returns on income and distributions

(a)

(i) NBT should be paid by every person who:
- imports any article, on the import value
- carries on the business of manufacture of any article, at the time of sale on the sales price

In the given scenario, PK is a watch manufacturer, which imports raw materials. Accordingly, it is liable to pay NBT on imports as well as on sale of manufactured watches. Therefore, the argument of the management is not valid and they should pay NBT on sales as well.

(4 marks)

(ii)

Output NBT on liable turnover (55,465,320 * 2%)		1,109,306
Less:	Input credit	
	NBT paid on imports	(831,980)
	Balance NBT payable	277,326

(3 marks)

(iii) If a person had a taxable loss in the year of assessment 2014/15, which consists of losses from trade or business, such a person is chargeable with ESC for the quarters covering the period from 1 April 2015 to 31 March 2016 for any quarter of which turnover exceeds Rs. 50 million.

Accordingly, for the quarter ended 31 December 2015, PK is liable to pay ESC at 0.25%

ESC payable (55,465,320 * 0.25%) 138,663

(4 marks)

(b)

Kandabby & Company	
Income tax payable for Y/A 2015/16	
	Amount (Rs.)
Accounting profit before tax	5,500,000
Less: Interest income (other source of income)	(273,000)
Drawings by the partners (Kandabby 1,500,000 and Sivaroshan 1,200,000 → disallowed	2,700,000
Salary paid to Yasiharan (100,000*12) → deductible expense since Yasiharan is a salary partner and he does share any losses incurred	-
Salary paid to Kandabby's wife → deductible expense and it will be included in Kandabby's profits and income under Section 25(6))	-
Rent paid to business premises →deductible expense	
Fuel cost for business travelling → deductible expense	-
Accounting depreciation	100,000
Less: Capital allowances	
- Computers (280,000 * 3 computers) → 840,000 * 25% = 210,000	
- Furniture (350,000 * 20%) = 70,000	
- Printer (930,000 * 25%) = 232,500	(512,500)
Donations → disallowed	354,000
Divisible profit	**7,868,500**
Add: Other income	
Interest income will be considered under partners' income. However, it will be treated as final income since the tax has been deducted	
Less: partnership allowance (Section 78)	(1,000,000)
Taxable Income	6,868,000
Partnership tax at 8%	**549,440**

(11 marks)

(b) Duties of a precedent partner

As the precedent partner of Kandabby & Company, Kandabby is required to send a return of the partnership to the Department of Inland Revenue on or before 30 November 2016 showing the following:

- divisible profit or loss and the distribution of profits of the partnership
- other income of the partnership
- the names and addresses of all the partners
- the apportionment of the divisible profit or losses of the partners according to the profit ratio, taking into account of the salaries and other remuneration of the partners and any interest on the partners' capital
- other income in accordance with shares in the partnership

(3 marks)

(Total: 25 marks)

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