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THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KB3 - Business Taxation and Law

June 2017

SECTION 1

BUSINESS LAW

Answer 01

(a)

Relevant Learning Outcome/s:
1.1 Laws governing companies in Sri Lanka 1.2 Definition of a company, characteristics of a company
Study text reference: Page 5

Section 4(2) of the Companies Act No. 07 of 2007 says that a company shall not have less than two shareholders, provided that a company may have a single shareholder where such single shareholder is the Secretary to the Treasury who is holding shares on behalf of the Government of Sri Lanka or is an individual or a body corporate.

Therefore, under the proviso to Section 4(2), the Secretary to the Treasury is permitted to be the sole shareholder of a company provided he is holding the shares on behalf of the Government.

Further, according to the proviso to Section 4(2) of the Act, a company can have a single shareholder who is an individual.

Therefore, Chathura Senarath, in his personal capacity and not as the Secretary to the Treasury, can be the sole shareholder of a company.

(b)

Relevant Learning Outcome/s:
4.2.2 Identify the process of appointment of Secretary and relevant qualifications
Study text reference: Pages 78, 79

- (i) After the judgement given in *Panorama Developments Ltd v Fidelis Furnishing Fabrics Ltd.*, the company secretary's role changed from that of a mere clerk to an officer of the company with extensive duties and responsibilities.

As a result, the company secretary will be called regularly to make representations on behalf of the company and enter into contracts on its behalf that come within the day-to-day running of the company's business; as the secretary is regarded as having authority to do such things on behalf of the company.

Further, the secretary will be entitled to sign contracts connected with the administrative side of the company's affairs, such as employing staff, ordering cars, and so forth.

- (ii) Unless the Articles of the company provide otherwise, the board of directors of the company shall have the power to remove the secretary of a company.

[Section 221(4)]

(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 relevant cases
2.3.2 Explain remedies of breach of duties
2.3.3 Discuss payments to promoters
Study text reference: Pages 30, 31, 35, 36

- (a) The contract given in the scenario falls within the scope of a pre-incorporation contract under the Act (Section 23).

As the scenario does not say anything to the contrary, it seems that the promoters have given the warranties implied under Section 24 in relation to a pre-incorporation contract, to the supplier of the electric three-wheelers (i.e. the company will be incorporated, and once incorporated it will ratify the contract).

Therefore, in such a situation, the company, once it comes into existence, may ratify the pre-incorporation contract under Section 23 of the Act.

Once so ratified, this contract shall be valid and enforceable as if the company was a party to it at the time it was entered into (Section 23(3)).

- (b) **Duties of the promoters in relation to incorporating the company**

- The promoters must not make any secret profit out of the promotion of the company.
- The promoters must make full disclosure to the company of all relevant facts, including any profit made by them in transactions with the company.

- (c) **Methods used by the promoters to reimburse the costs incurred by them and for the services rendered by them.**

- i. By including a payments clause in the Articles of the company, permitting payments to the promoters for the costs and services rendered by them.
- ii. Giving the promoters the option to buy a specified number of shares from the company at the nominal value within an agreed period of time.
- iii. Allowing the promoters to make a profit by entering into transactions with the company and thereby cover the promotional cost incurred. But in such an event, a proper disclosure of the profits is an essential requirement.

(Total: 10 marks)

Answer 03

(a)

Relevant Learning Outcome/s:
3.1 Types of shares, allotment and issue of shares
Study text reference: Page 47

Ordinary shares

The basic form of shares is ordinary shares.

Ordinary shares vest the owner with the following:

- one vote per share
- entitlement to participate equally in dividends
- if the company is wound up, share in the proceeds of the company's assets after all the debts have been paid

Holders of ordinary shares have a right to unrestricted participation in the dividends of the company and to the distribution of its remaining property. But they will be entitled to dividends only if the company makes profits.

Preference shares

In terms of Section 49(3) (b) of the Companies Act, a company can issue shares having a ranking above ordinary shares in specified aspects.

Preference shareholders have a priority to a fixed dividend and to a return of capital in a winding up.

Preference shares usually confer rights to preferential dividends, which may be cumulative or non-cumulative.

The terms relating to preference shares have to be clearly stated at the time of their issue.

(b)

Relevant Learning Outcome/s:
3.3.1 Analyse the following principles in relation to capital maintenance in a company (redemption, reduction of capital, financial assistance, share buy-back, minority buy-out)
Study text reference: Page 54

Section 66(c) of the Companies Act allows a company to redeem its shares if its Articles provide so, on a date specified in the Articles.

Section 66 also allows the Articles to specify the consideration, which shall be paid on such redemption.

The clause in the Articles of Sooriyakantha (Pvt) Ltd (SPL), as mentioned in the question, is in line with the Section 66 provisions mentioned above. Permission to redeem, the date of redemption and the consideration are all specified in the company's Articles.

Therefore the particular clause in SPL's Articles is legally valid and enforceable.

(Total: 10 marks)

Answer 04

(a)

Relevant Learning Outcome/s:
5.2.1 Explain the different types of resolutions which could be passed by the members of a company
5.2.2 Prepare resolutions for reappointment of directors, reappointment of auditors declaration of dividends.
Study text reference: Page 96

Subject to the provisions contained in the company's Articles, a resolution in writing signed by not less than 85% of the shareholders who would be entitled to vote on that resolution at a meeting of shareholders, who together hold not less than 85% of the votes entitled to be cast on that resolution, shall be as valid as if it had been passed at a meeting of those shareholders.

Within 5 working days of the passing of such a resolution, a copy of the resolution must be sent by the company to the shareholders who have not signed the resolution.

No prior notice needs be given to the shareholders of the signing of such a resolution.

Therefore, if the above criteria can be met by the shareholders of Watson (Pvt) Ltd., they can pass a circular resolution and appoint a new director to the company, without convening a general meeting.

[Section 144]

(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.
Study text reference: Pages 112, 125

(i) In a shareholders' voluntary winding up, the majority of the directors must make a declaration of solvency and deliver the same to the Registrar of Companies as stipulated in the Act.

But in a creditors' voluntary winding up, no such declaration needs to be made by the directors.

(ii) An administrator may not be appointed in the following situations:

- i) Where an order has been made to wind up the company
- ii) A receiver has been appointed for the whole of the property and the undertaking of the company (unless the person by whom or on whose behalf the receiver was appointed has consented)
- iii) An administrator has been appointed by the court previously (unless the court grants prior leave for a further appointment)

(Total: 10 marks)

Answer 05

(a)

Relevant Learning Outcome/s:
7.1.4 Explain “insider dealing” and relevant information
Study text reference: Pages 145, 146

Insider trading is commonly referred to as the unfair trade of securities by someone (an insider) who has access to material non-public information that gives him an unfair advantage over other traders who are not privy to this information.

In the given scenario, Berty receives such information from his brother, who works at the CSE, before such information goes into the public domain. Berty acts on this information and immediately sells his portfolio and makes a substantial gain.

The main points to be considered in this case are as follows:

- Berty has access to information which he knows is unpublished, price sensitive information.
- Therefore in the eyes of the law, Berty becomes a person who is connected with the companies in his portfolio.
- As a person connected with such companies, before Berty traded in those securities, he should have waited for a period of 6 months after getting to know of such information or should have waited till such information became public.
- But as he traded immediately and made a gain on such trading, at the expense of the other traders who were not privy to such information, it could be said that Berty has committed the offence of insider trading in this instance.

(b)

Relevant Learning Outcome/s:
8.1.3 Explain the role of Commercial Mediation Centre
Study text reference: Pages 154, 158

- (i) Alternative dispute resolution (ADR) is the process adopted for the resolution of disputes that do not involve the formal court structure of a legal system.
- (ii) The functions of the Commercial Mediation Centre of Sri Lanka (CMCSL) (as per Section 3 of the Act) are as follows:
- to promote the wider acceptance of mediation and conciliation for the resolution and settlement of commercial disputes
 - to encourage parties to resolve commercial disputes by mediation and conciliation
 - to conduct, and facilitate the conduct of proceedings for:
 - the settlement of commercial disputes
 - the adjustment of differences arising between parties in commercial matters by mediation and conciliation

(Total: 10 marks)

Answer 06

Relevant Learning Outcome/s:
1.2 Taxable income of a company
2.2.2 Compute tax payable on “deemed distributions” where applicable and payment of tax

(a)

	Rs.	Rs.
Adjusted profit from trade and business (Note 1)		33,395,000
Add: Other sources of income		
Dividend received from foreign companies of Rs. 215,000 → Exempt, if remitted through bank		-
Dividend received from unit trusts of Rs. 215,000 → Exempt, not part of TSI		-
Corporate debt securities of Rs. 422,000 purchased in 2013 → Exempt		-
Corporate debt securities purchased in 2014 = $(270,000 \times \frac{1}{9}) + 270,000$		300,000
Total statutory income		33,695,000
Less: Deductions under Section 32		-
Assessable income		33,695,000
Less: Qualifying payments		
Investment made in an existing undertaking, which could be qualified under Section 16c	19,000,000	
25% of investment		13,500,000
Donation made to a government hospital		300,000
Donation made to an approved charity where sick and needy people are maintained $\frac{1}{5}$ of the assessable income or 500,000 or qualifying payment, whichever is lower		200,000
Taxable income		19,695,000
Tax liability at 28%		5,514,600
Less: Tax credits		
Notional tax credit	30,000	
Self assessment payment	3,500,000	3,530,000
Balance tax payable		1,984,600

Note 1

	Rs.	Rs.
Net profit	35,185,000	
Less:		
Dividends received		430,000
Ground rent received is part of business income		-
Profit from disposal of motor lorry		5,352,000
Insurance receipt for van		3,500,000
Interest received		692,000
Add/ less		
Foreign travel: Purchase of machine disallowed since it is capital expenditure	272,000	
Foreign travel to negotiate with customers → disallowed	989,000	
Foreign travel allowed up to 2% of the previous year's profit (17,250,000 @ 2%)		345,000
Entertainment expenses	405,000	
Entertainment allowance	320,000	
Non refundable key money → cancelled accounting entry	250,000	
Non refundable key money → allowable amount		100,000
Loss on air conditioner disposed (since the capital allowance was not allowed)	22,000	
New air conditioner → this cannot be treated as a replacement and no capital allowance is given for it since it is used in an employee's residence.		
Book depreciation	1,425,000	
Donation	500,000	
Advertising cost related to the maintenance of a roundabout (452,000 x 25% is disallowed)	113,000	
<u>Taxable profit on disposal of lorry</u> Sales proceeds – (cost of acquisition – capital allowance granted) = 5,352,000 – (9,000,000 – 7,200,000) = 5,352,000 – 1,800,000	3,552,000	
Profit from disposal of van is the insurance claim since the capital allowance has been fully granted = 500,000		
Capital allowances		
No capital allowances on the work-in-progress of the building		
Furniture does not qualify for capital allowances since it is not yet used		
New van is a replacement		
Capital allowance for new van (4,000,000 – 3,500,000 = 500,000) 500,000 x 20%		100,000
Computers (100,000 x 25%)		25,000
PAYE tax paid by the employer	656,000	

Management fee paid = 2,250,000	250,000	
1% of the turnover (678,563,000 x 1%) = 6,785,630		
Allowable amount = 2,000,000		
	43,939,000	10,544,000
Adjusted profit from trade and business		33,395,000

(20 marks)

(b)

- (i) Dividend tax payable on voluntary distribution
= 8,000,000 – 1,000,000
= 7,000,000 x 10%
= 700,000

- (ii) Minimum requirement of distribution to avoid tax on distribution
= 10% of distributable profit
= 95,244,000 x 10%
= 9,524,400

Distribution needs to be made before 30 September of 2016

- (iii) Minimum distribution (10% of 95,244,000) = 9,524,400
Distributed amount = 8,000,000

Since the amount distributed is less than 10% of distributable profit

Tax payable on distributable profit

$$= (33\frac{1}{3}\% \text{ of the distributable profit} - \text{distributed amount}) \times 15\%$$

$$= 31,748,000 - 8,000,000 \times 15\%$$

$$= 3,562,200$$

Tax had to be paid on or before 30 October 2016

(5 marks)

(Total: 25 marks)

Answer 07

Relevant Learning Outcome/s:
3.2 Bodies of persons
4.1 Returns on income and distributions
4.2 Accounts and audit reports
5.1 Value Added Tax (VAT)

(a)

Computation of the tax liability of CSC	Rs.	Rs.
Gross receipts on revenue account (including entrance fees and subscriptions)		72,436,000
Receipts from members		
Entrance fees	4,321,000	
Subscriptions	30,140,000	
Lottery income (7,525,000 x 25%)	1,881,250	
Bar & restaurant income (12,650,000 * 90%)	11,385,000	
Car hire income	2,500,000	
		50,227,250
		69.34%

Since less than three-fourths of gross receipts are received from members, the club is deemed to carry on a business. In such a situation, the whole income arising from transactions with both members and others (including entrance fees and subscriptions) shall be deemed to be receipts from a business, and the club is liable to income tax for both business profits and other income.

Colombo Sports Club
Income tax computation for the year of assessment 2016/17

	Rs.	Rs.
Adjusted profit from trade or business (Note 1)		835,000
Add: Other sources of income		
Interest income from TBs (9,000,000/90*100)		10,000,000
Rent income		
Gross rent	5,500,000	
Less: Rates	(120,000)	
	5,380,000	
Less: 25% allowance for repairs	(1,345,000)	
Net rent	4,035,000	
It is assumed that net rent is greater than NAV, hence net rent is taxable		4,035,000
Total statutory income/assessable income		14,870,000
Less: Qualifying payments		
Donation made to Helpage Sri Lanka		
- Donation of goods are not a qualifying payment		-
Taxable income		14,870,000

Income tax liability @10%		1,487,000
Tax credit		
Notional tax credit		(1,000,000)
Balance tax payable		487,000

Note 1: Adjusted business profit/loss calculation

	Rs.	Rs.
	+	-
Net profit	14,895,000	
Less: Other sources of income and excluded/exempt income		
Profit on disposal of tools		800,000
Interest income		9,000,000
Rent income (a separate source of income)		5,500,000
Add: Disallowable expenditure		
Accounting depreciation on car → disallowed	700,000	
Donation → disallowed	1,000,000	
Rates & repairs on building given on rent → disallowed	440,000	
Less: Allowable expenditure		
Renewal allowance		
Crockery and cutlery purchases	1,000,000	
Less: Sale proceeds on discarded tools	(800,000)	
Renewal allowance		200,000
Depreciation allowances claimed for the year		
Car used for hiring (3,500,000 x 20%)		700,000
All other expenses are allowed		
	17,035,000	16,200,000
Statutory income from trade or business	835,000	

(12 marks)

(b) (i)

Computation of VAT Liability for the quarter ended 31 March 2017

	Rs.		Rs.
Total taxable supplies for the year			
Entrance fees	4,321,000		
Subscriptions	30,140,000		
Bar & restaurant income	12,650,000		
Car hire income	2,500,000		
Rent income	<u>5,500,000</u>		
	<u>55,111,000</u>		
Output tax			
Taxable supplies for the quarter, except lottery income ($\frac{1}{4} \times 55,111,000$)	13,777,750	x 15%	2,066,662
Lottery ticket income 7,525,000			
Less: Lottery winning awarded <u>6,300,000</u>	<u>1,225,000</u>	x 15%	<u>183,750</u>
	15,002,750		2,250,412
Less: Input tax			
Total input tax	1,570,000		
Less: Disallowable input tax			
Input tax on goods donation	(150,000)		
Input tax on motor car insurance can be claimed	-		
Allowable input tax	<u>1,420,000</u>		<u>(1,420,000)</u>
Balance VAT payable			830,412

(7 marks)

(ii)

- Name, address and VAT registration number of the supplier
- Name and address of the person to whom the supply is made
- Date on which the tax invoice was issued and its serial number
- Date of supply and description of goods or services supplied
- The word "TAX INVOICE" in a conspicuous place

(2 marks)

(c) (i)

- Particulars of sources of income
- Computation of total statutory income, assessable income, taxable income and income tax liability
- Value of assets and liabilities as at the last day of any year of assessment
- Any exempt profits and income

(2 marks)

(ii) As per the provisions of the Act, a person other than a company, in a situation where the turnover from trade, business, profession or vocation, for that year of assessment is not less than fifty million rupees or statutory income from

that trade, business, profession or vocation for that year of assessment is not less than twenty five million rupees, should furnish a statement of accounts and schedules when submitting the returns of income.

As the turnover of CSC for Y/A 2016/17 exceeds Rs. 50 million, it is required to furnish a statement of accounts.

(2 marks)

(Total: 25 marks)

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