

CA



THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KC 3 - Corporate Taxation

December 2016

Answer 01

Relevant Learning Outcomes:

3.1/3.2/2.1/2.2

Suggested Detail Answer:

- (a) Section 81 of the Inland Revenue Act provides that a non-resident person is assessable for income tax either directly or in the name of his agent in respect of all the profits and income arising or derived from Sri Lanka, whether such agent has the receipt of the profits and income or not.

This principle was upheld in the case of *Chivers and Sons Ltd v CIT* (1 CTC 124) where a company in England manufactured certain goods and supplied them to a company in Sri Lanka. The company in Sri Lanka stocked and sold these goods. The company in Sri Lanka also arranged for the supply on orders from local dealers, canvassed for orders. The Sri Lankan company received a commission from the company in England on all such orders received and executed. There was no formal agency agreement. It was held that the company in Sri Lanka was acting on behalf of the non-resident person and it was instrumental in selling the goods in Sri Lanka. As such all profits from the sale of goods in Sri Lanka was liable to income tax in Sri Lanka, even though the transaction takes place outside Sri Lanka.

The agent can be held liable to pay the tax of the non-resident person. Section 217 of the Inland Revenue Act defines an agent to include **“any person in Sri Lanka through whom such person or partnership is in receipt of any profits or income arising in or derived from Sri Lanka.”**

The agent chargeable with income tax may retain out of such income coming into his possession or control in his capacity as an agent such portion of such assets sufficient to pay the amount of such income tax under section 199. Therefore, PEL will be liable to pay income tax in Sri Lanka on the profits and income arising in Sri Lanka on the profits and income it derives through the operations of EPL performed in Sri Lanka on behalf of PEL.

The Double tax treaty between Sri Lanka and the UK in Article 5 provide that PEL will be liable to income tax in Sri Lanka under the concept of ‘agency PE’ where the agent ‘habitually exercises an authority to conclude contracts on behalf of the enterprise’ in Sri Lanka. Since EPL issues invoices and enters into transactions on behalf of PEL it will be considered to be an agent of PEL in Sri Lanka, and PEL will be required to pay income tax in Sri Lanka.

Therefore PEL will be liable to pay income tax on the profits and income arising from transactions that customers have directly entered into with EPL. However, PEL will not be required to pay income tax in Sri Lanka on the profits and income it derives from online transactions.

- (b) The taxable income and the income tax liability of PEL and EPL for the year of assessment 2015/16.

Income tax liability of PEL in Sri Lanka	
Income	
Directly transacted with EPL - £ 450,000* 200	90,000,000
Online transactions - Not liable to income tax in Sri Lanka	
Expenses	
Commission paid to EPL - £ 450,000 * 20% * 200	(18,000,000)
Cost + 100% margin	72,000,000
Cost of printing, binding etc. - 50% of 72,000,000	(36,000,000)
Profits arising in and derived from in Sri Lanka - liable to income tax	36,000,000
Income tax at 28%	10,080,000

Income tax liability of EPL in Sri Lanka	
Income	
Commission earned - £ 450,000 * 20% * 200	18,000,000
Expenses	
Staff Salaries	(7,200,000)
Local Travelling and courier charges	(2,500,000)
Foreign Travelling	0
Rent Expenses	(600,000)
Profits - liable to income tax	7,700,000
Income tax at 12%	924,000

- (c) (i) Remittance tax

Section 62(2) of the Inland Revenue defines "remittances" to include sums remitted or retained abroad **out of the profits and income chargeable with income tax** of the company and any sum received outside Sri Lanka by or on behalf of such company in relation to any trade, business, profession or vocation carried on in Sri Lanka by company, the profit of which are chargeable with income tax in Sri Lanka, such sums not including any dividend paid by a resident company to such non-resident company;"

Accordingly the amount retained outside Sri Lanka "out of the profits and income chargeable with income tax" will be considered to be "remittances". Therefore, the amount of profits that is chargeable to remittance tax in the case of PEL will be as follows;

- (ii)

	Rs.
Book Profit	36,000,000
Less: Income Tax	10,080,000
Profit available for remittances	25,920,000
Remittance tax at 10%	2,592,000

Accordingly, it is not necessary to withhold 10% on the total amount remitted by EPL to PEL (i.e. Rs. 90 Mn), but 10% of the after tax profits retained in UK.

- (d) Procedure to be taken up with the Tax Appeals Commission upon the receipt of the determination of the CGIR.
- Receipt of the determination of the CGIR.
 - Notify the Tax Appeals Commission (TAC) that the company intends to prefer an appeal within 30 days from the receipt of the determination.
 - TAC to forward a copy of such notification to the CGIR and require him to transmit in writing to the TAC and the aggrieved party and his authorized representative the reasons for determination.
 - The CGIR transmits his reasons in writing within 30 days of receiving the request from the TAC.
 - The person aggrieved may, if he is not satisfied with the reasons given by the CGIR prefer an appeal to the TAC within 30 days from the date of receipt of the reasons from the CGIR.
 - 25% of the tax as determined by the Commissioner General to be paid or a bank guarantee to be provided for an equal amount. Any amounts paid will be lying to the credit of the tax payer until the appeal is finally disposed of. A non-refundable payment of Rs. 2,500 to be made.
 - The secretary to the TAC to fix a date, time and place for the hearing of the appeal and to give 42 days notice within 30 days of the receipt of an appeal from the aggrieved party.
 - TAC to make a decision on the appeal within 270 days from the date of commencement of its sittings for the hearing of the appeal.

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes
4.1/4.3/3.3/5.2

Suggested Detail Answer:

(a) VAT computation

Output Tax	Value of Supply	Rate	Rs.	Rs.
Taxable Supplies				
Income received from designing residential houses	8,000,000	11	880,000	
Income received from renting premises	77,000,000	11	8,470,000	
Construction related services provided locally to other customers	13,000,000	11	1,430,000	
Total taxable Supplies	98,000,000			10,780,000
VAT Suspended Taxable Supplies				
Services provided locally to SVAT registered contractors	23,000,000	11		2,530,000
Excluded Supplies -	20,000,000			0
Total Output	141,000,000			13,310,000
Input Tax				
Input tax specifically relating to taxable supplies	14,000,000			
Common Input tax	2,000,000			
Input tax on Raw material and equipment used exclusively in Maldivian project	Cannot be claimed			
Cost of the Machinery imported to be used in the construction work	No input tax as exempt			
Total Input tax			16,000,000	
Less: Disallowed Input Tax	$20,000,000/141,000,000 \times 2,000,000$		283,688	
Allowable Input tax				(15,716,312)
Allowable Input tax for - Suspended Supplies-refund due	$23,000,000/121,000,000 \times 15,716,312$		2,987,398	
Allowable Input tax for - Other Supplies	15,716,312-2,987,398 or 100% of output tax whichever lower		10,780,000	
Allowable Input Tax	$(10,780,000+2,987,398)$		13,767,398	
Unabsorbed Excess Input Tax C/F	$(15,716,312-13,767,398)$		1,948,914	
Less credits				
SVAT Credit Voucher				(2,530,000)
Net VAT payable				0

- (b) In terms of section 22 of the VAT Act, input tax is deductible only on expenditure attributable to taxable supplies and not on exempt or excluded supplies. Any common input tax deductible should be calculated on a pro rata basis using an appropriate criteria such as turnover, square area etc. Accordingly, the company could claim input tax on the expenditure incurred in respect of the commercial building as the supply/leasing of commercial buildings are liable for VAT.

However, as the supply of residential accommodation is exempt from VAT the applicable portion of input tax on residential accommodation cannot be claimed. Further, since the enterprise has not entered into an agreement with the BOI even though the cost is more than US\$ 10 million, this input cannot be claimed

If the project is approved under Section 22(7) of the VAT Act the company will be able to purchase the items used for the construction of the commercial area without paying VAT by registering under the Suspended VAT scheme.

- (c) In terms of section 79(2) of the Inland Revenue Act, Mr. Damian if employed in Sri Lanka during the last three months (from 1 January) of a given year of assessment will be considered as a non-resident individual for income tax purposes in Sri Lanka as his stay in Sri Lanka is for less than 183 days.

In terms of section 2 of the Inland Revenue Act, an individual being a non-resident is chargeable with income tax only on the profits and income arising in or derived from Sri Lanka which includes all profits and income derived from services rendered in Sri Lanka.

Accordingly, as per local tax statute a non-resident individual is chargeable with income tax in Sri Lanka if he renders services in Sri Lanka. Accordingly his employer has a legal obligation to withhold the taxes payable by him in accordance with the PAYE tax table No 4 and remit same to the Department of Inland Revenue on or before the due date.

Also in terms of the Article 15 (Employment) of the UK – Sri Lanka DTA (which should be read in conjunction with the local tax statute – Section 97), a resident of UK has to fulfill all three conditions set out below for not to be liable to income tax in Sri Lanka in respect of an employment exercised in Sri Lanka.

- 1 he is present in Sri Lanka for a period or periods not exceeding in the aggregate 183 days in the fiscal year concerned; and
- 2 the remuneration is paid by, or on behalf of, and employer who is not a resident of Sri Lanka; and
- 3 the remuneration is not borne by a permanent establishment or a fixed base which the employer has in Sri Lanka.

Even though Mr. Damian fulfills the first condition, he does not fulfill the other two conditions. Accordingly he is liable for income tax in Sri Lanka on the remuneration including any cash or non-cash benefits received by him for the services rendered in Sri Lanka.

(d) When a company is a holding company or a subsidiary company, within the meaning of Section 529 of the Company's Act, a number of consequences relating to income tax liability arise. These consequences are;

- The applicability of thin capitalization rules in terms of Sections 26 (1) (x) or 26 (1) (y) which places restriction on the deductibility of interest paid on loans obtained from a holding or a subsidiary company.
- Non availability of the concessional income tax rate of 12% available to companies having a taxable income not exceeding Rs 5 million in a year of assessment, in terms of part B of the second schedule to the Act.
- Non availability of the concessional income tax rate of 12% available to persons from any undertaking with an annual turnover not exceeding 750 million in the year of assessment 2015/16 in terms of section 59B.
- Applicability of transfer pricing regulations in terms of section 104A of the Act (1)

(Total: 25 marks)

Answer 03

Relevant Learning Outcomes							
1.2/5.3/3.3/4.1/6.1							
(a)	Ceylon Sugar Ltd						
	TIN - 123456789						
	Year of Assessment 2015/2016						
	Computation of Income Tax Payable						
	Based on the Statutory Accounts for the Year Ended 31 March 2016						
			Notes	Agriculture	Production	Seeds	Total
				Rs. '000	Rs. '000	Rs. '000	Rs. '000
		Net profit before taxation (per accounts)	1	41,449	49,551	175,000	266,000
		Add:					
		Depreciation (Accounting)		10,000	73,000	8,000	91,000
		Tax gain on Disposal of Fixed Assets	3	-	12,000	-	12,000
		Agricultural research		-	-	37,000	37,000
		Penalty		-	700	-	700
		Advertising (1/4th of 1200 and 200)		-	300	-	300
		Entertainment		-	12,000	-	12,000
		Provision for doubtful debts (Specific)		-	-	-	-
		Provision for doubtful debts (General)		3,000	-	-	3,000
		Donation		-	250	250	500
		Provision for gratuity		-	11,000	-	11,000
		Amortization of land lease	5	8,250	1,650	1,100	11,000
		Interest payable to related parties disallowed		-	90,000	-	90,000
				21,250	200,900	46,350	268,500
	Less						
	Government grant (section 12)		-	-	60,000	60,000	
	Depreciation allowance	2	27,633	15,000	5,000	47,633	
	Accounting gain on Disposal of Fixed Assets		-	12,000	-	12,000	
	Dividend		-	9,000	-	9,000	
	300% of agricultural research expenses (48,000*3)		-	-	144,000	144,000	
	Payment of gratuity		-	8,000	-	8,000	
	Land lease allowed		6,750	1,350	900	9,000	
			34,383	45,350	209,900	289,633	
	Profit / (loss) from trade or business		28,316	205,101	11,450	244,867	
	Total Statutory Income		28,316	205,101	-	244,867	
	The losses (adjusted for tax purposes) B/f from Y/A 2014/15		-	1,800,000	170,000	1,800,000	
	Loss set off (35% of total statutory income)		-	85,703	-	85,703	
	Profit from seed production		-	-	11,450		
	The losses (adjusted for tax purposes) c/f to Y/A 2016/17		-	1,714,297	158,550	1,714,297	
	Total Assessable Income		28,316	119,398	-	159,164	
	Less qualifying payments						
	Approved donation (limited to 1/5th of the AI)		-	500	-	500	
	Taxable Income		28,316	118,898	-	158,664	
			10%	12%	Exempt		
			Section 48A		Section 16B		
	Total Tax Liability		2,832	14,268	-	17,099	

Ceylon Sugar Ltd									
TIN - 123456789									
Year of Assessment 2015/2016									
Notes to the Computation of Income Tax Payable									
							Rs. '000		
Note 1									
Net profit before taxation (per accounts)									
Net profit before taxation of both cultivation and production							91,000		
Less: Net profit before taxation of cultivation									
Open market sale price per MT of sugar cane paid to the farmers	4,545								
Actual harvesting cost of MT of sugar cane harvested by the company included in cost of production including depreciation	4,200								
Profit from cultivation per MT	345								
MTs of sugar cane harvested by the company	120,142								
Total profit on cultivation (Section 16 and 48A)	41,448,990	41,449							
Net profit before taxation of production			49,551						
Note 2									
Depreciation allowance on fixed assets - 2015/16									
Description	Year of Purchase	Cost	Rate	Depreciation allowance Agriculture	Depreciation allowance Production	Depreciation allowance			
		Rs. '000	%	Rs. '000	Rs. '000	Rs. '000			
B/F from the Y/A 2014/15				7,000	15,000	5,000			
Add: Tax depreciation on additions during the year									
Water distribution line	2015/16	10,000	6.33%	633	-	-	Section 25 1(a)(iv)		
Agricultural tractors	2015/16	100,000	20%	20,000	-	-	Section 25 1(a)(ii)		
Lab equipment	2015/16	11,000	0.00%	-	-	-	Section 25 1(a)(iii) (B) - Refer section 25 (2)		
Less: Tax depreciation on assets disposed or fully claimed									
				-	-	-			
Tax depreciation for the Y/A 2015/16							27,633	15,000	5,000

Note 3										
Tax (Loss)/gain on Disposal of Fixed Assets										
Description	Year of purchase	Cost	Tax depreciation claimed	Tax WDV	Sales Proceed	Taxable Profit	Years	rate		
Machineries used for production	2004/05	30,000	30,000	-	12,000	12,000	11	12.50%	Section 25	1(a)(iii)(A)
Note 4										
Amortization of land lease										
		Agriculture	Production	Seeds						
		75%	15%	10%						
ha leased	4,000	3000	600	400						
Total ground rent paid up front	450,000	337,500	67,500	45,000						
Lease period	50	50	50	50						
Amount deductible in terms of section 25(1)(p)	9,000	6,750	1,350	900						
Amount charged to the Statement of comprehensive income	11,000	8,250	1,650	1,100						

(Total: 25 marks)

(b)

- (i) According to the case of New Portman Ltd and W. Jayewardene and others, it was held that the reasons given in the letter of intimation issued by the Inland Revenue Department should be adequate.

However the position taken by the Assistant Commissioner is correct for the following reasons-

- research expenses referred to in section 25 (1) (i) do not include market research expenses
- the construction of sheds for labourers is a capital expenditure on which tax depreciation could be claimed at 10%. (Please refer Theobald vs Commissioner of Income Tax) (TL – Volume)

Accordingly there will be no grounds to appeal against the assessment to be issued. Hence we recommend that additional tax due to IRD be computed and paid. Company may make a written request to waive off any penalties. "

- (ii) In terms of section 26 (4) no deduction will be allowed under sections 25, 26 or 27, in respect of any expenditure if it appears to the Assessor or Assistant Commissioner that the debt or such part thereof attributable to such expenditure remains unpaid and an assessment will be issued disallowing the entirety or any part of such expenditure. However, if it is proved to the satisfaction of the Assessor or Assistant Commissioner within three years from the end of that year of assessment, that such debt has been paid within two years from the end of that year of assessment, the Assessor or Assistant Commissioner will, revise the assessment allowing the deduction.

Accordingly going forward we recommend that outstanding expenditure be paid within two years from the end of any year of assessment in which such expenditure were incurred."

- (c) "In terms of item (D) of proviso to section 32 (5) (b) no loss shall be deducted which is incurred by a company in which there had been a change of ownership otherwise than by way of testate or intestate succession, except against the statutory income of such trade or business of the company in which the loss was incurred. A change of ownership of a company is deemed to have occurred where more than one third of the issued share capital of the company is held at any time in the year of assessment for which the claim for deduction is made, either directly or through nominees, by persons who did not hold such capital at any time in the year of assessment in which the loss was incurred.

When there is a change of ownership of the company, losses of the company can only be set off against the profits and income of the same trade or business in which the loss was incurred.

Accordingly brought forward tax losses of the company will not be available to set off against any profits made from the business of agriculture based tourism as it would be a different business/undertaking.

In terms of section 16B an undertaking for producing of agricultural seeds or planting materials, or primary processing of such seeds or materials, is exempted from income tax for five years, commencing on 1 April 2011. Accordingly the tax exempt period will be over on 31-3-2016 and the company will be liable to pay income tax on the profits and income of the undertaking of producing sugar cane seeds from the Y/A 2016/17. The brought forward losses from both production of sugar as well as production of seeds could be set off against the profits of the proposed export of seeds as such exports will be considered as an expansion of the existing undertaking of producing sugar cane seeds.

(In terms of section 32(6), where the profits and income of an undertaking were exempt from income tax under section 16B, the excess, if any, of the total of any losses incurred in such undertaking during the exempt period, over such profits and income of that undertaking exempt during the exempt period succeeding the year of assessment in which such loss in that undertaking was incurred, can be deducted from the total statutory income (subject to the 35% restriction) of the person who carries on that undertaking in the year of assessment in which such exemption ceases to apply. Any residue, shall be deemed to be a loss incurred by such person in that undertaking in the year of assessment immediately succeeding that year of assessment, and can be deducted in the subsequent Y/A subject to 35% restriction.) "

- (d) "As per item (xi) of PART II (a) of the first schedule to the value Added Tax Act, supply and import of agricultural seeds and agricultural plants are exempted from VAT. Also in terms of item (xxvii) of PART II (b) of the first schedule locally manufactured sugar (effective from 1/1/2008) is also exempt from VAT. As all the supplies made by the company are exempt from VAT, the company is not registered for VAT and not entitled to claim any input credit relating to its expenditure.

In terms of section 22 (6) (ii) if the supply of goods or services received is not connected to a taxable activity any input tax attributable to the supply of goods or services received cannot be claimed and form a part of such expenditure.

As the company is exempt from VAT and not entitled to claim Input VAT it can capitalize the input tax suffered by it as part of the cost of lab equipment. This is evident from section 25 (7) (f) (iv) of the Inland Revenue Act."

- (e) "Effective from the quarter commencing on or after 1 April 2012, any person carrying on any trade, business, profession or vocation will not be liable to ESC, if he has a taxable income from such trade, business, profession or vocation, which is assessed for income tax for the year of assessment immediately prior to the commencement of the year of assessment to which such quarter belongs. In effect, ESC will be payable only on the turnover of any trade, business, profession or vocation, which is eligible for income tax exemption or incurs a loss in the preceding year of assessment.

As the company did not have a taxable income (was incurring tax losses and had exempt income) in the Y/A 2014/15 and before it was liable to pay ESC up to and including in the Y/A 2015/16 at the rate of 0.25%, the company could set off such ESC paid against the income tax payable during the Y/A in which the relevant quarter is a quarter and immediately succeeding 4 year of assessment.

As the company has a taxable income in the Y/A 2015/16 it is not required to pay ESC in the Y/A 2016/17.

However as per the budget proposals announced on 10-11-2016, the company will be liable to pay ESC from the Y/A 2017/18 even if it had a taxable income in the previous Y/A, at 0.5%. Such ESC paid could be set off only against the income tax payable during the Y/A in which the relevant quarter is a quarter and immediately succeeding 2 Ys/A. Also the maximum ESC to which any person or partnership is liable for any relevant quarter of Rs.30 Million (Rs.120 Million per Y/A) would be removed effective from Y/A 2017/18.

(Total: 50 marks)

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