

CA



THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KC 3 - Corporate Taxation

June 2017

SECTION 1

Answer 01

Relevant Learning Outcome/s:
2.1 Assessing income tax liability of a non-resident person
3.1 Statutory provisions
5.2 Transfer pricing

(a)

- (i) In terms of Section 2 of the IRA, income tax is imposed in Sri Lanka at the rates specified in the IRA in respect of the profits and income,
- wherever arising in the case of a person **resident in Sri Lanka**, and
 - arising in or derived from Sri Lanka in the case of a person **who is not a resident in Sri Lanka**

“Profits and income arising in or derived from Sri Lanka” includes all profits and income derived from services rendered in Sri Lanka or from property in Sri Lanka, or from business transactions in Sri Lanka, whether directly or through an agent.

According to Section 79, a company having its registered or principal office in Sri Lanka, or where the control and management of its business is exercised in Sri Lanka, shall be deemed to be a resident of Sri Lanka.

Accordingly, as KYC is a company incorporated in India and its operations are managed from India, it will be considered a non-resident for income tax purposes in Sri Lanka. Accordingly, KYC will be liable to income tax in Sri Lanka on any profits and income “arising in or derived from Sri Lanka”.

Sri Lanka has entered into a double tax treaty with India (“DTA”). Article 7 of this DTA provides that, the profits of an enterprise of one contracting state will only be taxable in the other contracting state, where such enterprise carries on business in that other state through a permanent establishment (“PE”) in that other state. If the enterprise creates a PE in such other state, then the profits of the enterprise attributable to such PE will be taxed in that other state.

Per Article 5(3)(b) of the DTA, “The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, constitutes a permanent establishment, but only where activities of that nature continue (for the same or connected project) within the contracting state for a period or periods aggregating more than 90 days within any 12-month period.”

Based on the information provided, employees of KYC have been in Sri Lanka from June 2016 to August 2016, and then 4 to 5 days each month from September 2016 to March 2017. As such it can be reasonably assumed that employees of KYC have been in Sri Lanka for a period or periods aggregating more than 90 days within any 12-month period. As such KYC will be considered to have a permanent establishment (“PE”) in Sri Lanka and will be liable to pay income tax in Sri Lanka.

- (ii) When there is a double tax agreement between two countries, any resident that has paid tax in the other contracting state can claim credit for the taxes paid, against the tax liability on such income in the country of residence. Per Article 23 of the DTA, any tax that KYC pays in Sri Lanka can be claimed as a credit against the tax liability of KYC in India, on the profits attributable to the PE in Sri Lanka. However, the credit will be limited to the amount of tax payable in India on the same income on which tax is payable in Sri Lanka.

(7 marks)

(b)

KYC (Pvt) Ltd - India
Income tax liability for the year of assessment 2016/17

	USD (‘000)	LKR (‘000)
Set-up fee	2,000	300,000
Merchant tie-up fee		
• Up to 100 merchants	100	15,000
• Balance 7 merchants (USD 1,500 x 7)	10.5	1,575
Annual fee 2016/17 <i>If candidates have taken the annual fees for 5 months as $750 * 5/12 = 312.5$, they can obtain marks for that answer.</i>	750	112,500
Total income		429,075
Less: expenses		
According to Section 27, any expenditure in the nature of head-office expenditure can be deducted from the profits of the non-resident company, for a sum equal to the lesser of:		
(a) the amount of such expenditure, or		
(b) the amount equal to ten percent of such profits or income (profit adjusted for tax purposes before charging head-office expenses)		
	In LKR (‘000)	
Staff salaries (based on time spent)	35,750	
Staff travelling costs to Sri Lanka (air fare)	5,400	
Accommodation and living expenses in Sri Lanka	9,800	
Apportioned administrative costs of the KYC office in India	12,000	
Rent on premises in India where the servers are maintained (apportioned based on floor area)	<u>3,900</u>	
Total head-office expenses (A)	<u>66,850</u>	
10% of the profits (10% x 429,075) (B)	42,907.5	
Amount allowed under Section 27 (lower of A or B)		(42,907.5)
Profits and income liable to income tax		386,167.5
Income tax liability		
Liable at 10% (item 31 of 5 th schedule)		38,616.7

Remittance tax		
Profits remitted abroad (386,167.5 – 38,616.7)		347,550.8
Remittance tax at 10%		34,755
Total income tax liability		73,371.7

(6 marks)

- (c) Per Section 94 of the IRA “where royalties or fees for technical services are:
 (i) borne directly or indirectly by a person resident in Sri Lanka; or
 (ii) deductible under Section 25,

such royalties or fees for technical services shall be deemed to be profits and income arising in or derived from Sri Lanka.”

Any non-resident person is required to pay income tax on such deemed profits and income arising in or derived from Sri Lanka, and any person in Sri Lanka making such payments to such non-resident person is required to withhold tax as specified in Section 95.

NBSL is a company resident in Sri Lanka. However, Section 94 defines “fees for technical services” as follows:

“For the purpose of this section the term “fees for technical services” means payments of any kind, received as consideration for managerial or technical or consultancy services including the provision of services of technical or other personnel other than employment or professional services performed through a fixed base”.

Accordingly, the definition excludes any “professional services performed through a fixed base”. As explained in part (a) above, KYC has created a PE in Sri Lanka and it can be considered that the services are performed through a fixed base. As such there is no withholding tax obligation on NBSL when making payments to KYC.

(3 marks)

- (d) (i) Section 104A of the Inland Revenue Act provides, that any transaction (other than an international transaction), which takes place between two associated undertakings, must be carried out at an arm’s length price (ALP).

The transfer pricing regulations (in Regulation 7) provide that two undertakings will be deemed to be “associated undertakings” when “one enterprise holds, directly or indirectly, shares carrying not less than fifty percent of the voting power in the other undertaking”.

As NB Leisure is a fully owned subsidiary of NBSL, both these entities are deemed to be associated undertakings. As such, all transactions between the two entities must be carried out at an arm’s length price (ALP).

- (ii) The transfer pricing regulations provide five methods to determine whether a given transaction is carried out at an ALP. Of these five methods, the comparable uncontrolled price (CUP) method can be used to compare the price charged for the given transaction from the associated undertaking with a comparable uncontrolled transaction, or a number of such transactions.

Accordingly, if the cost-sharing basis of the benefit provided by NB Leisure is similar to the cost-sharing basis of the benefit provided by a third party merchant, then the transaction between NBSL and NB Leisure can be considered to be at an ALP.

However, if the cost-sharing basis of the benefit provided by NB Leisure is different to that provided by the third party merchant, then reasons for such difference must be justified when preparing the transfer pricing documents. If not the DIR would take the view that the transaction is not carried out at an ALP.

(6 marks)

- (e) Section 83 of the Inland Revenue Act (duly amended) provides,

“Where the Commissioner-General is of the opinion that the correct amount of the profits of a non-resident person arising in or derived from Sri Lanka from any trade or business cannot be readily ascertained, for the reason that such person is unable to furnish the fuller or further returns or fuller or further information referred to in subsection (12) of Section 106, or the documents or the other documents referred to in Subsection (13) of Section 106, relating to such trade or business, the Commissioner-General shall, where such non-resident person makes a declaration of such inability, ascertain such profits as a percentage of the sum receivable by such person from such trade or business, provided that such percentage shall in no circumstances be less than six.”

Accordingly, KYC could obtain prior written approval from the CGIR after negotiating the deemed profit percentage and pay its taxes based on such percentage

(3 marks)

(Total: 25 marks)

Answer 02

Relevant Learning Outcome/s:
3.1 Statutory provisions
4.2 VAT on Financial Services
6.1 New tax legislations

(a)

	Rs.	Rs.
Net profit before income tax		3,317,562,000
Add:		
VAT on supply of financial services charged to the income statement		848,683,000
NBT on supply of financial services charged to the income statement		113,157,000
Depreciation charged to the income statement		407,750,000
Emoluments payable and charged to the income statement	W1	<u>3,107,481,000</u>
Less:		
Economic depreciation		<u>(366,250,000)</u>
Total value addition prior to tax		7,428,383,000
Less: VAT payable as per Chapter IIIA		
01.01.2016 - 01.05.2016	122/366 @ 11%	(238,000,525)
02.05.2016 - 11.07.2016	71/366 @ 15%	(188,875,230)
12.07.2016 - 31.10.2016	112/366 @ 11%	(218,492,285)
01.11.2016 - 31.12.2016	61/366 @ 15%	<u>(162,273,085)</u>
	12.4426229 @ 5%	(807,641,125)
Less: NBT payable	@ 2%	(129,818,468)
	14.4426229 @ 5%	
Total value addition		6,490,923,407
VAT on financial services is payable at		
01.01.2016 - 01.05.2016	122/366 @ 11%	238,000,525
02.05.2016 - 11.07.2016	71/366 @ 15%	188,875,230
12.07.2016 - 31.10.2016	112/366 @ 11%	218,492,285
01.11.2016 - 31.12.2016	61/366 @ 15%	<u>162,273,085</u>
		807,641,125
NBT is payable at 2%		129,818,468

(10 marks)

Workings

W1	Personnel expenses	Rs.
	Salaries	1,563,400,000
	Bonuses	224,653,000
	Employer's contribution to EPF	187,608,000
	Employer's contribution to ETF	46,902,000
	Employer's contribution to pension fund	93,804,000
	Contribution to savings fund	22,000,000
	Other allowances and staff related expenses	958,394,000
	Gratuity provision	10,720,000
		3,107,481,000
W2	Total value addition prior to tax = 114.4426%	7,428,383,000
	VAT and NBT (12.4426% + 2% = 14.4426%)	114.442623
	Total value addition subject to financial VAT = 100%	6,490,923,406.44

(b)

- On or after 01.01.2017 there is only one taxable period of one year and the return of VAT on financial services is to be filed on a yearly basis within six months from the end of the taxable period of one year. Before 01.01.2017, the taxable period was for six months and two returns were required to be filed before the end of the following month of the respective taxable period.
- However the VAT on financial services has to be paid on a monthly basis on estimated amounts as before
- These monthly estimated amounts have to be adjusted to reflect actual amounts on a half yearly basis, before the 20th day of the succeeding month of each six months. Before 01.01.2017, this adjustment had to be made annually
- As per the new Subsection 2A (a) introduced by the amendment act No. 20 of 2016, every registered person who furnishes a return that is not in such form or fails to furnish an interim estimate every six months or fails to furnish the contents of such return or the interim estimate as specified by the CGIR, shall be deemed not to have furnished a return.
- As per Subsection 2A (b), the ACIR is required to be informed in writing within 30 days from the due date of the submission of the return or interim estimate, if such particulars in such form and relevant schedules are not furnished.
- Where any registered person receives any notice under paragraph (b), such person has to within 30 days of receipt of such notice, furnish to the CGIR all such particulars in such form and relevant schedules required to make the return submitted a proper return. If not, the time bar provision will not be applicable

(7 marks)

(c)

- (i) Per Regulation 18 published in the Gazette Notification No. 1857/8 of 9 April 2014, interest income relating to financial instruments “Held to Maturity Investments” and “Loans and Receivables” is to be calculated using the effective interest rate (EIR).
- (ii) For financial instruments classified as “available for sale”, any gains or losses recognised in the other comprehensive income statement is not taxed or allowed a deduction (Regulation 18.4).

When such financial instruments (available for sale) are derecognised and/or disposed of, the cumulative gains or losses transferred to the income statement will be taxed or allowed a deduction (Regulation 18.4).

(5 marks)

- (d) Per Section 10(1)(j) of the Inland Revenue Act No. 10 of 2006 (duly amended) any dividend paid on or after 1 April 2008 by a company not resident in Sri Lanka to any shareholder resident in Sri Lanka, where the amount of such dividend is remitted to Sri Lanka through a bank, is exempt from income tax.

Per Section 61(1)(b) and Section 65(1)(e) of the Inland Revenue Act No. 10 of 2006 (duly amended), a resident company need not pay/deduct tax on/from any dividend distributed to any person who is exempt from income tax under Section 10.

Per Section 10(1)(l), any dividend paid to a shareholder of a company out of dividend received by that company from a company not resident in Sri Lanka through a bank, is exempt from income tax, if the first mentioned dividend is paid within three months of the receipt of the second mentioned dividend.

(3 marks)

(Total: 25 marks)

Answer 03

Relevant Learning Outcome/s:	
1.1	Comprehensive income tax computations
1.2	Impact of Taxation on business and finance decisions
3.2	Case law
3.3	Application of statutory provisions and case law
5.1	Fiscal incentives and limitation
5.4	Providing tax advise

(a)

Somachandra and Sons (Pvt) Limited
TIN No. 000000000

Year of assessment 2016/17

Computation of income tax payable (based on statutory accounts for the year ended 31 March 2017)

	Notes	Rs. '000	Rs. '000	Rs. '000
		Total	Manufacturing	F&L
Profit before taxation		103,902	99,390	4,512
Add:				
Depreciation		68,102	67,930	172
Recovery of bad debts written off in previous years		-	-	-
Tax gain on disposal of fixed assets	2	3,500	3,500	-
Entertainment expenses		10,000	10,000	-
Market research expenditure*		-	-	-
Business promotion (25% of Rs. 20,000)		5,000	5,000	-
Advertising expenses (120 + (25% of Rs. 12,000 - 120))		3,090	3,090	-
CSR project		5,000	5,000	-
Amortisation of the secret formula		6,833	6,833	-
Legal expenses		150	150	-
Loss of cash**		-	-	-
Rent (CEO's apartment)	3	1,125	1,125	-
Collective impairment → 2% of the trade receivables		6,131	6,131	-
Individual impairment		-	-	-
Provision for gratuity		24,624	24,124	500
Training		-	-	-
PAYE tax paid		5,000	5,000	-
Foreign travelling	4	3,400	3,400	-
		141,955	141,283	672
Less:				
Depreciation allowance	1	55,900	55,000	900

Gain from sale of fixed assets (accounting)		4,500	4,500	-
Net dividend income		2,650	2,650	-
Intangible asset (the secret formula) 25(1)(b)(ii)		1,000	1,000	-
Interest income received from listed corporate debt securities issued prior to 1 April 2011		9,687	9,687	-
Interest income from government securities		3,600	3,600	-
Net interest income from fixed deposits		1,800	1,800	-
Gratuity paid		3,000	3,000	-
		82,137	81,237	900
Profit from trade or business (as adjusted for tax purposes)		163,720	159,436	4,284
Summary of sources of income				
Profit from trade or business (adjusted for tax purpose)		163,720	159,436	4,284
Interest income	5	6,000		
Total statutory income/assessable income		169,720		
Deduction from assessable income				
Donation - community project		(5,000)		
Taxable income		164,720		
Tax payable at 28%		46,122		
10% relief given to local manufacturers who are in the business since 1970 (Section 59K)		(4,464)		
Income tax payable		41,657		
<u>Dividend tax payable on the final dividend</u>				
Dividend distributed		33,593		
Less: Net dividend received		(2,650)		
Dividend subject to dividend tax		30,943		
10% dividend tax		3,094		

(25 marks)

- * Market research should be allowed. The Inland revenue act does not disallow it specifically, though not given a triple deduction. Although it relates to the instant noodles production that has not yet commenced, it is an expenditure incurred in the production of income.
- ** Loss of cash – this could be argued. Should be allowed.

Somachandra and Sons (Pvt) Limited
Notes to the Tax computation

Note 1 - Depreciation Allowance 2016/17	Rs '000		
Depreciation Allowance 2015/16			50,000
Add: Depreciation Allowance on additions during the year			
Land	31,306	0%	-
Furniture	2,000	20%	400
Motor Vehicles (Lorries to transport goods)	20,000	20%	4,000
Computer hardware	10,000	25%	2,500
Assets which were not fully depreciated during the Y/A 2015/16 of Rs. 50,000 includes tax depreciation on machine disposed during the year Rs. 1,000 (capital allowance cost can be claimed on the year of disposal)			
Machinery purchased in 2009/10	8,000	12.5%	(1,000)
Depreciation Allowance 2016/17			55,900

Note 2 - Tax gain on Disposal of Fixed Assets	
Cost of the machinery purchased in 2009/10	8,000
Tax depreciation claimed @ 12.5%	(7,000)
Tax written down value	1,000
Sales proceed	4,500
Tax gain on Disposal of Fixed Assets	3,500

Note 3 - Rent (CEO's apartment)	
Rent paid to the Land Lord	1,680
Rental value	240
Higher of the two	1,680
The employment income is more than Rs 180,000. Benefit is restricted to Rs 180,000	(180)
Amount from which 75% is disallowed	1,500
	1,125

Note 4 - Foreign Travelling	
Overseas travelling and accommodation	5,000
Profit adjusted for tax purpose of the previous year	80,000
2% of above - 26 (1) (c) (B)	1,600
Amount allowed	1,600
Balance disallowed	3,400

Note 5 - Interest Income	
Interest income received from listed corporate debt securities issued after 01.01.2013	-
Interest income from Government securities	4,000
Net Interest income from fixed deposits	2,000
	6,000

(b) In terms of Section 8(1)(o) of the Inland Revenue Act, any sum that does not exceed two million rupees, paid to any employee by the employer, being a sum paid as compensation for loss of any office or employment consequent to:

- (i) the voluntary retirement by such employee in accordance with a scheme which in the opinion of the Commissioner General is uniformly applicable to all employees employed by such employer; or
- (ii) the retrenchment of such employee by such employer in accordance with a scheme approved by the Commissioner of Labour

is exempt from income tax.

Any amount above Rs. 2 million will be liable to tax at the following concessionary rates of income tax along with the other terminal benefits received, if any.

- If the period of service is less than 20 years:

First 2 million	Nil
Next 1 million	5%
Balance	10%
- If the period of service is equal to or more than 20 years:

First 5 million	Nil
Next 1 million	5%
Balance	10%

Compensation for loss of office or employment paid under a scheme which in the opinion of the Commissioner General is not uniformly applicable to all the employees, will be liable to income tax at the normal income tax rates applicable to individuals, subject to a maximum rate of 16%.

Per the proposed voluntary retirement scheme (VRS), three years' salary would be paid to executive officers, whereas other employees would receive only two years' salary. This VRS will not be approved by the Commissioner General of Inland Revenue as there is no uniformity. Therefore VRS has to be planned in a uniform manner to all the employees in order to minimise the tax exposure to all of them.

The company has decided to bear the income tax liability of all the employees under the VRS to relieve them from tax. In the above situation, such tax payable by the company will not be allowed for tax purposes according to Inland Revenue Act.

(7 marks)

- (c) In terms of Section 25 of the Inland Revenue Act, for the purpose of ascertaining the profits or income of any person from any source, all outgoings and expenses incurred by such person in the production of such profit and income (except for what is specifically disallowed under Section 26), is deductible.

According to the case of “Hayley and Co Ltd Vs the Commissioner of Inland Revenue”, it was held that a cash loss incurred is allowed to be deducted for income tax on the following grounds:

- What is allowable for income tax is not only an expense; even outgoings are also allowable.
- Outgoings should be incurred for the production of income.
- The loss represents working capital and not fixed capital and therefore not a capital expenditure.

Therefore, the cash loss of Rs. 25,524 should be allowed as a deduction, as an involuntary outgoing incurred for the production of income.

(6 marks)

(d)(i)

In terms of Section 16B of the Inland Revenue Act, the profits and income within the meaning of paragraph (a) of Section 3, other than any profits and income from the disposal of any capital asset, of any person or partnership from any undertaking for producing of agricultural seeds or planting materials, or primary processing of such seeds or materials, shall be exempted from income tax for each year of assessment within the period of five years, commencing on 1 April 2011.

In this section “primary processing” means cleaning, sizing, sorting, grading, chilling, dehydrating, cutting, canning or packaging for the purpose of preparation of such produce for the market.

The company purchases coffee seeds from farmers to produce the S&S brand coffee and does not own any estates to grow coffee. Also once the coffee is produced, the seeds cannot be identified. Primary processing means even after processing, the earlier product could be identified as it is. For the above reasons, the company cannot claim the exemption under Section 16B.

If the company has used the seeds cultivated by the company itself, it could have claimed an exemption up to the point of taking to the factory in terms of Subsection (3) of Section 16B, which is reproduced below

“In relation to an undertaking which consists of producing agricultural seeds or planting materials and utilising such seeds or materials in agriculture or horticulture, such produce shall be deemed to have been sold for such purpose at the open market price prevailing at the time of such deemed sale, and the exemption granted under Subsection (1) shall be applicable to that undertaking, on the profits and income computed on the basis of such deemed sale”

(7 marks)

(d)(ii)

Per Section 34(2)(s) of the Inland Revenue Act a qualifying payment means “an investment of not less than fifty million rupees in the acquisition of fixed assets made by any person on or after 1 April 2011 but before 1 April 2014 in the expansion of any undertaking which would have been qualified for exemption under Section 16C or Section 17A had such undertaking commenced to carry on business on or after 1 April 2011:

provided however, where such investment is made in any high tech plant, machinery or equipment which is acquired for energy efficiency purposes or for technology upgrading purposes or introducing any new technology or for power generation using renewable energy resources in the expansion of such undertaking on or after 1 April 2011, but prior to 1 April 2015, such investment shall comprise a qualifying payment .

Accordingly, a qualifying payment can be claimed under Section 34(2)(s) when the following conditions are met.

1. The undertaking shall make an investment of not less than fifty million rupees in fixed assets after 1 April 2011 but before 1 April 2015 → “Investment criteria”
2. The investment shall be in the expansion of such undertaking → “Expansion criteria”
3. Undertaking would have been qualified for exemption under Section 16C or 17A had such undertaking commenced to carry on business on or after 1 April 2011.

A mere investment on fixed assets would not be considered as a qualifying payment unless there is an expansion of that undertaking (by way of increased turnover, employment etc.). In this case the company replaced the machinery in the production line that were fully damaged due to a fire that occurred inside the factory with similar type of machinery. Also, out of the Rs. 62 million, Rs. 40 million was received by way of an insurance claim. Accordingly, no expansion has taken place and the minimum investment has not been made though the last condition is met. Hence the company is not entitled to claim the qualifying payment under Section 34 (2)(s).

(5 marks)

(Total: 50 marks)

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