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

# **SUGGESTED SOLUTIONS**

**KB3 – Business Taxation and Law**

**June 2018**

# SECTION 1 BUSINESS LAW

## Answer 01

### Part (a)

Relevant Learning Outcome/s: 1.3.4
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Page 14
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The following are instances where the courts have been known to lift the veil of incorporation.

1. When the company has been used as a cover for a deliberate wrongdoing. (Gilford Motor Co Ltd V Horne; Hatton National Bank Ltd v Jayawardane & others)
2. When the number of members fall below the statutory minimum.
3. When the controlling shareholder uses the company as his agent, or when the corporate body is abused for an unlawful or improper purpose.
4. To prevent a fraud.
5. To determine the place of residence of the company, for the application of specific statutes e.g. tax laws.
6. To prevent the deliberate evasion of contractual obligations.
7. To promote the interests of national security, or to ensure conformity with public policy.
8. To require holding and subsidiary companies to prepare group accounts.
9. To prohibit a company from giving financial assistance to another to purchase the shares of that company or of its holding company.

### Part (b)

Relevant Learning Outcome/s: 4.2.1
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Study text reference – Page 79
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The landmark case mentioned in the question is “Panorama Development Ltd. v Fidelis Furnishing Fabrics Ltd.”

This case established the nature of authority given to the company secretary:

- The nature of his authority is apparent or ostensible on behalf of the company

Further, this case established that the company secretary can exercise his authority on behalf of the company, in the following areas,

- He can make representations on behalf of the company, in relation to the day-to-day running of the company’s business.
- He can enter into contracts on behalf of the company, in relation to the day-to-day running of the company’s business.
- He can sign contracts on behalf the company, in relation to its administrative matters such as employing staff, ordering cars, etc.

**(Total: 10 marks)**

## Answer 02

(a)

Relevant Learning Outcome/s: 2.2.2
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Study text reference – Page 28, 32
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The proposed name of Amal and Kamal's company is "The Golden Oldies (Private) Limited." The existing name of the company is "Golden Oldies Company Limited".

Section 7(1)(a) of the Companies Act states that "a company shall not be registered by a name which is identical with the name of any other company".

Further section 7(3) states that in determining whether the two names are identical the word "**the**" where it is the 1<sup>st</sup> word in the name, will be disregarded.

Section 7(3) also states that when the words "**company limited**" appears at the end of the name, they too will be disregarded.

Section 7(3) also states that when the words "**(private) limited**" appear at the end of the name, they too will be disregarded.

Therefore, when the provisions of section 7(3) are applied to the two names in question, for comparison purposes, both names will read as, "Golden Oldies".

Therefore, [as per sections 7(1) and 7(3)], the proposed name cannot be registered as it is identical to the name of an already existing company.

(b)

Relevant Learning Outcome/s: 2.4.1
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Study text reference – Page 28,32
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The Object Clause is a clause in the Articles of association of a company, which spells out the objectives or purposes for which the company has been formed; or the businesses that can be engaged in by the company.

Under the former Companies Act (No. 17 of 1982), it was compulsory for a company to have an Object Clause. But Section 13 of the new Companies Act (No. 7 of 2007), gives the freedom for a company to either include or not include the Object Clause in its Articles.

Therefore, Amal and Kamal can dispense of the Object clause from the articles of association of the proposed company.

**(Total: 10 marks)**

### Answer 03

Relevant Learning Outcome/s: 3.2.2
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Study text reference – Page 52
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(a)

Dividends are treated as a distribution under section 56 of the Companies Act. In order to make a distribution or in other words, for a company to declare a dividend, the company must pass the solvency test.

To pass the solvency test in terms of section 57 the Companies Act, it should be established that the company is able to pay its debts as they become due in the normal course of business; **and** that the value of the company's assets is greater than the aggregate value of its liabilities and its stated capital.

Applying the assumption given in the question, and the data given in the latest available financial statements of the company to the solvency test formula, the following can be observed;

- The 1<sup>st</sup> condition of being able to pay its debts as they become due in the normal course of business" has been fulfilled by the company, as per the assumption given in the question itself.
- To determine whether the company has passed the 2<sup>nd</sup> condition the following calculation is considered:
  - Total Assets = Rs. 80 million
  - Total liabilities + stated capital = Rs. 220 million
  - Therefore; Total Assets are less than the Total liabilities and stated capital.
  - Therefore the 2<sup>nd</sup> condition has NOT been fulfilled by the company.
- As a result, the company will not pass the Solvency Test.
  - *identifying the solvency test formula,*
  - *applying the given financial data to this formula, and*
  - *arriving at the conclusion that the company will not pass the solvency test*

Therefore, the statement made by Martin, that **"based on the latest financial statements of the company, it is not advisable for the company to declare this dividend"**, is correct.

(b)

Relevant Learning Outcome/s: 3.4.1
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Study text reference – Page 46/56
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Part (i)

Equity capital refers to the capital raised through the sale of shares in a company. These funds amount to the ownership of the company.

Debt capital refers to the capital raised primarily in the form of money, which must be paid back by the company over a period of time together with interest at an agreed rate.

Part (ii)

Advantages of Debt Capital over Equity Capital

- Raising Debt Capital can be faster than raising Equity Capital, as the proposed company is an asset intensive one.
- As the proposed company is an asset intensive one, raising Debt Capital will be a cheaper option than raising Equity Capital, since the company will be able to secure their loans with assets, which in turn makes the company a low credit risk one from the financing institutions' point of view.
- As the lender does not get ownership interest in the company, (but only a security hold over the assets which may be mortgaged), the owner is allowed to remain in the driver's seat without having to be answerable to the investors.

**(Total: 10 marks)**

**Answer 04**

Relevant Learning Outcome/s: 5.3.1
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Study text reference – Page 99
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(a)

- Proposal no. (i) of UPL is in accordance with Section 113(3) of the Companies Act. [As per Section 113(3), a company can have its registered office at the office of a chartered accountant, provided it is so mentioned in the register];

[In order to change its registered address to that of its chartered accountant, the company must 1<sup>st</sup> pass a board resolution authorising this change and submit the prescribed form (Form 3) to the Registrar of Companies at least 5 working days prior to the effective date of the change.]

- Proposal no. (ii) is not in accordance with section 116(1) and 116(3a).  
[If a company intends to keep its certificate of incorporation at a location other than at its registered address, it should give prior notice of such intention to the Registrar. Therefore, as the company has not given such notice to the registrar, the proposal is not in accordance with the provisions of the Act.]
- Proposal no. (iii) is not in accordance with section 116(1)(h).  
[A company must keep at its registered office its completed financial statements for the last 10 years. As it is proposed to keep only the statements for the last 5 years, this proposal is not in accordance with the provisions of the Act.]
- Proposal no. (iv) is not in accordance with section 116(1)(b).  
[Section 116(1)(b) says that a company must keep minutes of its shareholders' meetings for the last 10 years at its registered office. But as only the last 7 years minutes are proposed to be so kept, this proposal is not in accordance with the provisions of the Act.]
- Proposal no. (v) is in accordance with section 116(1)(d) of the Act.

(b)

Relevant Learning Outcome/s: 6.1.1
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Study text reference – Page 117 & sections 319 & 270(e) of the Act
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FPL is solvent (able to pay its debts) and the directors are in a position to give a declaration of solvency in this regard.

This rules out a winding up by court and a creditor's voluntary winding up, as for both these methods, the company should be in a position where it is unable to pay its debts. This leaves the company with the option of going for a shareholders' voluntary winding up.

Further, the company's Articles of Association have fixed a time period of 10 years for the company to be in existence, and this time period has lapsed. This too is a ground available for a shareholders' voluntary winding up.

Therefore, considering the above, it is seen that the best suited option of winding up for the company is a shareholders' voluntary winding up.

*(sections 319 & 270(e) of the Act)*

**(Total: 10 marks)**

## Answer 05

Relevant Learning Outcome/s: 7.1.4
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Study text reference – Page 145/147
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(a)

- (i) “Insider trading” means the unfair trading in securities by an “insider” (as per the Act) who has non-public information which gives him an unfair advantage over other traders who are not privy to such information.
- (ii) The following are persons who are “connected with a company”:
1. A director of that company or a related company;
  2. One who occupies a position as an officer or employee of that company or a related company or a position involving a professional or business relationship between himself and the first company or a related company;
  3. One who has access to information in relation to listed securities, which he knows, is unpublished price sensitive information and which is reasonable to expect him not to disclose except in the course of performing his duties.

(b)

Relevant Learning Outcome/s: 8.2.1
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Study text reference – Page 159
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Some of the key features of conciliation are as follows:

- Conciliation is a dispute resolution method outside the court system.
- The parties to the dispute will nominate a neutral third party called a conciliator, to assist the disputing parties to arrive at a settlement.
- Conciliation is consensual.
- It uses a non-binding adjudication process which does not involve a court of law.
- It takes the form of a “round table discussion” between the disputing parties and the conciliator, as the conciliator actively participates in the discussion with the disputing parties.
- The resolute of the dispute and the adherence to this resolution, is entirely in the hands of the disputing parties.

**(Total: 10 marks)**

## SECTION 2 BUSINESS TAXATION

### Answer 06

Relevant Learning Outcome/s: 1.2/1.3/2.1.2

Study Text reference: Chapter 02

		Rs.
<b>Taxable profit from trade or business (Note 1)</b>		<b>61,356,000</b>
Add: Other sources of income :		
Interest income – FCBU		Exempt
Interest income - Fixed deposits (540,000/90 x 100)		600,000
<b>Total Statutory Income</b>		<b>61,956,000</b>
Less: Deductions under Section 32		-
<b>Assessable Income</b>		<b>61,956,000</b>
Less: Allowance for Qualifying Payments		
Donation made to Municipal Council		(850,000)
<b>Taxable Income</b>		<b>61,106,000</b>
<b>Tax on taxable income at 10%</b>		<b>6,110,600</b>
<u>Tax on dividend distributed</u>		
Gross Dividend	20,000,000	
less: Dividend to Unit trusts	(400,000)	
Dividend to "Api wenuwen Api Fund"	(100,000)	
	<u>19,500,000</u>	
Tax on Dividends @ 10%		<b>1,950,000</b>
		8,060,600
<u>Tax on Distributable Profit</u>		
10% of Distributable Profit for Y/A 2016/17	7,523,580	
No dividend declared on or before 30.09.2017	-	
1/3 of Distributable Profit	25,078,600	
Less- Dividend distributed o or before 30.09.2017	-	
	<u>25,078,600</u>	
Tax on Distributable Profit at 15%		<b>3,761,790</b>
<b>Total Tax Liability</b>		<b>11,822,390</b>
<b>Less: Tax Credits :</b>		
Withholding tax on interest income		(60,000)
Tax on dividend paid		(1,950,000)
Self-assessment payments		(5,000,000)
<b>Balance Tax payable</b>		<b>4,812,390</b>



**NOTE - 01 - ADJUSTED BUSINESS PROFIT/ LOSS  
CALCULATION**

		+	-
<b>Profit Before Taxation</b>		<b>102,645,000</b>	
<b>Less: Other Sources of Income:</b>			
Interest income - FCBU			1,345,000
Interest income - Fixed Deposit			540,000
<b>Add/ less</b>			
Listing expenses		1,750,000	
1% of the value of the Initial Public Offer			1,500,000
Training expenses - 300% allowed			4,800,000
Rent on residence	800,000		
Benefit for PAYE - since employment income > Rs. 1,800,000	(180,000)		
	620,000		
Disallowed 75% , since remuneration > Rs. 600,000 per annum		465,000	
Book depreciation		24,435,000	
Donation		850,000	
Subscription to club		500,000	
Subscription to professional body - allowable		-	
Accounting Profit from disposal of generator			220,000
<b>Taxable loss on disposal of Generator</b>			
Sales proceeds – (cost of acquisition – Depreciation allowance granted)			
= 1,500,000 – (4,800,000 – 3,200,000)			
= 1,500,000 – 1,600,000			100,000
Loss cannot be adjusted to the cost of replaced asset.			
<b>Depreciation allowances</b>			
Data Processors (energy efficient)-25,000,000 x 50%			12,500,000
Generator -5,400,000x33 1/3%			1,800,000
Car - not entitled for depreciation allowances			-
Amortisation of patent		620,000	
Cost of Patent-100% allowed			6,200,000
		<b>131,265,000</b>	<b>29,005,000</b>
<b>Adjusted profit from trade or business</b>		<b>102,260,000</b>	
<b>Exempt profit -102,260,000/788,600,000 x 315,440,000</b>		40,904,000	
(Under section 13 (ddd))			
<b>Taxable profit from business</b>		<b>61,356,000</b>	

**Answer 07**

Relevant Learning Outcome/s: 3.2.3/4.2/5.1.1/5.1.2/5.1.5
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Study Text reference: Pages 187/184/170/176/164
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(i)

Computation of the Tax Liability of the Club - (KHC)

	Rs.	Rs.
Gross receipts on revenue account (including entrance fees and subscriptions)		8,213,450
<b>Receipts from members</b>		
Entrance Fees	2,169,700	
Subscriptions	1,921,500	
Conducting Class - 2,270,250 x 20%	454,050	
Food & Beverage Sale - 980,000 x 30%	294,000	
Interest income from loan	872,000	5,711,250
		<b>69.54%</b>

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

**Kandy Health Club**  
**Income Tax computation for the Year of Assessment 2017/18**

	Rs.
Adjusted profit from trade or business (Note 01)	2,518,195
Add: other sources income - Interest	872,000
<b>Total Statutory Income</b>	<b>3,390,195</b>
Less : Deductions under section 32	
Lower of brought forward loss - 925,000	
and 35 % TSI-(35% of 3,390,195) 1,186,568	
Loss Claimed for the year	(925,000)
<b>Assessable Income</b>	<b>2,465,195</b>
Less: Allowance for Qualifying Payments	-
<b>Taxable Income</b>	<b>2,465,195</b>
<b>Tax Liability @ 10%</b>	<b>246,520</b>

**NOTE - 01 - ADJUSTED BUSINESS PROFIT/ LOSS CALCULATION**

	Rs.	Rs.
	+	-
<b>Excess of income over expenditure</b>	<b>2,301,195</b>	
<b>Less: Other Sources of Income – Interest from Loans given</b>		872,000
<b>Add : Disallowable Expenditure</b>		
Accounting depreciation - disallowed	495,000	
Expense relating to the annual get together - disallowed: not incurred for the production of income	750,000	
<b>Less: Allowable Expenditure</b>		
Sale proceed of asset exchange	- 700,000	
TWV (Cost - Depreciation allowance claimed)		
(1,200,000 - 1,200,000 x 20% 3)	- 480,000	
Taxable profit	- 220,000	
<b>Exchange of old van with new van will be a qualifying replacement</b>		
Depreciation allowance - (Cost - Tax profit ) x 20%		
(1,000,000 - 220000 ) x 20%		156,000
Cars and Three wheeler used for travelling - no depreciation allowance		
	3,546,195	1,028,000
<b>Statutory Income From Trade or Business</b>	<b>2,518,195</b>	

- (ii) Return of income should be furnished by KHC on or before 30th of November 2018. Failure to furnish a return within the prescribed time will render a penalty not exceeding Rs. 50,000
- (iii) As per the provisions of the VAT Act, a registered person may make an application to cancel the registration:
- (a) at any time after the lapse of a period of 12 months following date of registration . **and**
  - (b) the value of taxable supply during any taxable period does not exceed the limits required for the registration.

Accordingly, KHC is in a position to cancel the VAT registration when it proves to the CGIR that the value of taxable supply does not exceed the limits required for the registration. As the taxable supplies of the KHC including the food and beverage department sales is less than Rs. 12 million per annum, they are in a position to cancel the VAT registration.

## VAT implications upon the cancellation

Any goods or services forming part of the assets of a taxable activity shall be deemed to be supplied by that person in the course of taxable activity at a time immediately prior to the date of cancellation.

Accordingly, the Department of Inland Revenue is in a position to inform KHC to pay VAT on Rs. 2 Million worth of capital assets considering it as deemed supply if those assets are liable for VAT purposes.

(b) (i)

<b>Output Tax</b>			<b>Rs.</b>		<b>Rs.</b>
Zero rated Supplies - Exports			12,875,000	0%	-
Suspended Supplies - Sales to exporters			21,257,000	15%	3,188,550
Taxable Supplies - Local Sales			41,720,000	15%	<u>6,258,000</u>
			<b>75,852,000</b>		<b><u>9,446,550</u></b>
<b>Input Tax</b>					
On import of raw materials					2,900,000
On local purchases					350,000
On machinery purchased					112,000
On insurance of motor car used by CEO			- not claimable		-
On repairs to the motor coach			- not claimable		-
					3,362,000
Unclaimed brought forward input VAT					<u>-</u>
					3,362,000
<u>Input tax claimable without restriction</u>					
<u>Zero rated supplies + SVAT Supplies x Claimable input tax</u>					
Total supplies					
(12,875,000 + 21,257,000) x 3,362,000				1,512,838	
75,852,000					
Balance subject to 100% of output tax on taxable supplies	6,258,000	or	1,849,162	1,849,162	
Total input tax claimable					<u>(3,362,000)</u>
VAT Payable					6,084,550
Less: SVAT Credit Vouchers					(3,188,550)
Installments paid					(1,500,000)
<b>Balance Payable</b>					<b>1,396,000</b>

- (ii) As per Value Added Tax Act, the definition of “Taxable Activity” includes, the exploitation of any intangible property such as patents, copyrights or other similar assets where such asset is registered in Sri Lanka or the owner of such asset is domiciled in Sri Lanka.

As sale of brand is within the purview of “exploitation of any intangible property” it is a taxable activity and income accruing to the company from the sale of brand is liable for VAT.



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