THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC 3 - Corporate Taxation

June 2018

Answer 01

Relevant Learning Outcomes:
2.1/5.3/1.3

(a)

(i) In terms of Section 79 of the Inland Revenue Act No. 10 of 2006 hereinafter referred to as "(IRA)", where a company or a body of persons has **its registered or principal office in Sri Lanka,** or where **the control and management of its business are exercised in Sri Lanka**, such company or body of persons shall be deemed to be resident in Sri Lanka. As Ambal is not a company incorporated in Sri Lanka and does not have its registered office in Sri Lanka **it will be considered as a non-resident of Sri Lanka**.

Section 2 (charging section) of the IRA states as follows
"-----for every year of assessment commencing on or after April 1, 2006 in respect of the profits and income of every person for that year of assessment–

(a) Wherever arising, in the case of a person who is resident in Sri Lanka in that year of assessment; and
(b) arising in or derived from Sri Lanka, in the case of every other person."

The term "profits and income arising in or derived from Sri Lanka" as defined, includes all profits and income derived from services rendered in Sri Lanka, or from property in Sri Lanka, or from business transacted in Sri Lanka, **whether directly or through an agent**.

Accordingly, where a non-resident derives profits and income from services rendered in Sri Lanka, directly or through an agent, then such person shall be charged with income tax in Sri Lanka. **As employees of Ambal were providing services in Sri Lanka when setting up the framework and technology platform, fees received in respect of such services would be construed as profits and income arising in Sri Lanka and would therefore be liable to income tax in Sri Lanka.**

However, in terms of clause 1 of Article 7 of the Double Tax Treaty between Sri Lanka and India (DTA) which supercedes the IRA, Ambal will be liable to income tax in Sri Lanka **only if it carries on business in Sri Lanka, through a permanent establishment** (PE) in Sri Lanka. Clause 2(b) of article 5 of the DTA specifies that where an entity provides services through its employees or other personnel, for a period or periods aggregating more than 90 days within any 12-month period, it would constitute a PE. As the employees of Ambal have been in Sri Lanka from May 2016 to February 2017, **Ambal would have created a PE in Sri Lanka**. **As such Ambal will be liable to pay income tax in Sri Lanka** on the profits as attributable to that PE.

Running Royalties and Brand Use Charges are considered as "Royalty" payments for the use of technology and the right to use the brand. In terms of Section 94 of the IRA, where royalties or fees for technical services are—

(a) borne directly or indirectly by a person resident in Sri Lanka; or

(b) 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. **As the royalty will be borne, and deducted for corporate tax purposes by Kirisudu, a company resident in Sri Lanka**, such royalty paid for using the technology and for the right to use the brand **will be liable to Income Tax in Sri Lanka**.

The term 'Royalty' is not defined in the IRA. However as per Article 12 of the DTA, the term "Royalties" means payments of any kind, received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films or films or tapes or discs, used in Television or Radio Broadcasting, any Patent, Trade Mark, Design or Model, Plan, Secret Formula or Process, or for the use of, or the right to use Industrial, Commercial or Scientific Equipment, or for Information concerning Industrial, Commercial or Scientific Experience.".

Section 95 of the IRA requires a resident person making a royalty payment to a non-resident, to deduct income tax at the appropriate rate specified in the Fourth Schedule to IRA (**which is 20%**), or where there is a DTA, at the appropriate rate specified in such DTA (which is 10%). In terms of Section 39 of the IRA. The Gross Royalty payable by any person in Sri Lanka to any person outside Sri Lanka, being Royalty, which arises or is deemed by section 94 to arise in Sri Lanka, to such person, is chargeable with income tax at the appropriate rate specified in the Fifth Schedule to this Act. (which is 15%).

Accordingly, Kirisudu must withhold and remit to DIR, 10% of the 'Royalty' payable to Ambal, obtain a Tax Clearance Certificate, and remit the balance 90%, direct to Ambal India.

(b)

Ambal Dairy Company Ltd – India
TIN : 123456789 0000
Year of Assessment 2017/18
Computation of Income Tax Payable
Based on the Audited Accounts for the Financial Year Ended 31 March 2018

	Note	USD	LKR
Net profit before taxation (per accounts)	**1**	74,860	11,229,000
Add: Head office expenses		7,800	1,170,000
Less: Royalty on which 10% had been withheld		12,160	1,824,000
Adjusted profit before head office expenses		70,500	10,575,000
Less: Head office expenses allowed	**2**	7,050	1,057,500
Profit from business (as adjusted for tax purposes)		63,450	9,517,500
Total Statutory Income/ Assessable Income/ Taxable Income		63,450	9,517,500
Income Tax payable at 12% under section 59B		7,614	1,142,100
Profit available for remittance		67,246	10,086,900
Less: Remittance of tax payable at 10%		6,725	1,008,690
Total Income tax payable		14,339	2,150,790

Note 1 - Profit before tax			
Initial set up cost		300,000	45,000,000
Running Royalties		10,750	1,612,500
Brand Use charges		1,410	211,500
Total Income		312,160	46,824,000
Less: Expenses			
Employee related cost (including airfare) for employees in Sri Lanka		73,500	11,025,000
General Administration cost including Employee cost in India		7,800	1,170,000
Cost of equipment used in the project		156,000	23,400,000
		237,300	35,595,000
Profit before tax		74,860	11,229,000

Note 2 - Head office expenses allowed		
Adjusted taxable profit before head office expenses		70,500
10% of total adjusted taxable profits		7,050
Head office expenses charged to P/L		7,800
Head office expenses allowed		7,050

(c) If the Initial set up process was **sub-contracted** to Suriya (Pvt) Ltd, employees of Ambal would only need to visit Sri Lanka for 5-7 days. This does not mean that Ambal will not be creating a Taxable Presence in terms of Section 2 of the IRA and a Permanent Establishment in terms of Article 5 of the DTA. Please note that in terms of Section 2 of the IRA "profits and income arising in or derived from Sri Lanka" is defined as including all profits and income derived from services rendered in Sri Lanka, or from property in Sri Lanka, or from business transacted in Sri Lanka, whether **directly or through an agent.** In terms of clause 2(b) of article 5 of the DTA where an entity provides services through its employees or **other personnel,** for a period or periods aggregating more than 90 days, within any 12-month period, it would constitute a PE. Under this scenario Suriya (Pvt) Ltd would be treated as an agent or other person who carried out the services for Ambal – India. Accordingly, Ambal – India would have still been liable to pay tax in Sri Lanka (including remittance tax) on the USD 50,000 (USD 300,000 – USD 250,000) less the employee related cost (including airfare) of the employees who worked in Sri Lanka during the 5-7 days and any head office expenses subject to the 10% restriction.

The opinion of the Finance Director may be correct, in stating that subcontracting the work would be more tax efficient, as a lesser amount of tax could have been paid. However, the business activity would have been less profitable.

(d) In terms of section 79 (2) of the IRA, an individual, who is physically present in Sri Lanka for one hundred and eighty three days or more, during any year of assessment, shall be deemed to be resident in Sri Lanka, throughout that year of assessment.

Accordingly, as per the Domestic Tax Statute, all the employees of Ambal – India who stayed in Sri Lanka from May 2017 to February 2018, would be deemed to have been residents, and would therefore have been liable to tax in Sri Lanka on the profit and income wherever arising, if not for the following exemption granted in terms of section 13(zz).

"The profits and income of any individual who is not a citizen of Sri Lanka, and who is employed in Sri Lanka in any undertaking, being profits and income arising or derived from outside

Sri Lanka, during the period commencing from April 1, 2008, and ending on the date of cessation of such employment"

Accordingly, as per the Domestic Tax Statute, all the employees of Ambal – India who were in Sri Lanka for the project, would be liable to tax in Sri Lanka, only on the profit and income (total remuneration received in respect of services provided in Sri Lanka whether paid in Sri Lanka or outside Sri Lanka either in foreign currency or in LKR) arising in, or derived from, Sri Lanka.

Also, in terms of Clause 2 of Article 15 "Dependent Personal Services" of the DTA which must be read in conjunction with the IRA, remuneration derived by an individual who is a resident of one of the Contracting States (i.e. India) in respect of an employment exercised in the other Contracting State (i.e. Sri Lanka), is taxable only in the first mentioned State (i.e. India), if all three conditions set out below, are met.

(a) the recipient is present in that other State for a period or periods not exceeding, in the aggregate, 183 days in the year of income or in the year of assessment, as the case may, be, of that other State;

(b) the remuneration is paid by, or on behalf of an employer, who is not a resident of that other State; and

(c) the remuneration is not deductible, in determining taxable profits, of a permanent establishment or a fixed base, which the employer has in that other State.

As all the employees were present in Sri Lanka for more than 183 days and as the remuneration is deductible by the Sri Lanka PE of Ambal – India, in computing its taxable profit, even though the remuneration is paid by Ambal India, all such employees of Ambal – India are subject to income tax in Sri Lanka, on the total remuneration received in respect of services provided in Sri Lanka.

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes:
4.1, 4.4, 3.1

(a) In terms of section 113 of the Inland Revenue Act No 10 of 2006 (duly amended), thereafter referred to as the IRA, income tax is required to be paid in four installments /quarterly installments on or before 15th August, 15th November & 15th February of that year of assessment, and 15th May of the succeeding year of assessment.

The quarterly installment should be equal to one-quarter (1/4th) of the tax payable for that year of assessment. This is called the current year basis.

Since SPL accounts are finalized only in July of the following year of assessment, SPL had not been able to pay quarterly income tax payments based on the 'current year basis' on or before the due dates. This will lead to penalties as specified in section 173(3) of the IRA as follows:

(a) a penalty of ten per centum of such tax; and
(b) where such tax is not paid before the expiry of thirty days after it has begun to be in default, a further penalty of two per centum of the tax in default, in respect of each further period of thirty days, or part thereof, during which it remains in default.

Provided that—

(i) the total amount payable as a penalty shall not exceed fifty per centum of such tax in default;

(ii) where any person has paid as quarterly installment of tax for any year of assessment a sum which is not less than one-quarter of the income tax payable by such person, for the year immediately preceding that year of assessment, such person shall not be liable to any penalty, in respect of such quarterly installment of tax, under the preceding provisions of this section, until the thirtieth day of September immediately succeeding the end of the year of assessment in respect of which such quarterly installment of tax became due.

Accordingly, SPL could have paid the quarterly installments of tax based on the previous year of assessment, as set out above and paid any balance if any, on or before the 30th September the next succeeding year of assessment, without attracting any penalty.

The fact that SPL has not paid any income tax in respect of the previous year of assessment, due to BOI exemption, is not a valid reason to refrain from making the quarterly installments. In terms of section 173(3), SPL could have ascertained the income tax which would have been otherwise payable by it for the year preceding that year of assessment, if not for the BOI exemption.

(b) In terms of item (x) of paragraph (a) of Part II of the First Schedule to the VAT Act import of supply of fertilizer is exempt from VAT.

There is no such exemption given for chemicals. And accordingly import and supply of chemicals is liable to VAT at 15%.

Also the exemption is available only on **import of** the Poly Tunnels and other material for green houses, **the supply of** Poly Tunnels and other materials for green houses are liable to VAT whereas

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Refer item (xxxiii) of paragraph (c) of Part II of the First Schedule to the VAT Act.

In terms of the Section 7 of the VAT Act, services provided to a person outside Sri Lanka to be consumed or utilized outside Sri Lanka shall be zero rated provided the payment is received in foreign currency from outside Sri Lanka, through a bank in Sri Lanka.

Accordingly, even if the Brand Promotion Fees are received in foreign currency from outside Sri Lanka through a bank in Sri Lanka, and the services were provided to a person outside Sri Lanka as the services are consumed in Sri Lanka to promote the sale of fertilizer in Sri Lanka, such fees cannot be considered as zero-rated supplies. Accordingly, such fees are liable to VAT at the standard rate of 15%.

Interest Income is exempt from VAT in terms of item (x) of paragraph (b) of Part I of the First Schedule to of the VAT Act.

(c)

Agri Pohora (Private) Limited
VAT computation for the quarter ended 31 March 2018

Output Tax			
	Value of supply	**Rate**	**VAT**
Fertilizer	12,000,000	Exempt	-
Chemicals	4,000,000	15%	600,000
Poly tunnels and other materials	2,000,000	15%	300,000
Interest income	180,000	Exempt	0
Brand promotion fees	900,000	15%	135,000
Total supply/total output tax	**19,080,000**		**1,035,000**
Less: Input Tax			
VAT paid at customs			376,450
Packing material for fertilizer		No input tax	0
Bottles for chemicals			142,000
VAT on administration expenses			15,250
Total input tax			533,700
Add: disallowable input tax			9,735
Allowable input tax			511,035
Allowable input tax or 100% of output tax which is lower			511,035
Unabsorbed input tax			
Balance tax payable			523,965

(d) In terms of Section 83 of the VAT Act, APPL can be considered a Manufacturer and is required to pay VAT monthly, as set out below. (Section 26)

VAT for January 2018 should be paid on or before 20th February 2018
VAT for February 2018 should be paid on or before 20th March 2018
VAT for March 2018 should be paid on or before 20th April 2018

VAT return for the Quarter ended 31st March 2018 should be filed on or before 30th April 2018. (Section 21)

(Total: 25 marks)

Answer 03

(a)

Electro Techno Distributors PLC
TIN : 123456789 0000
Year of Assessment 2017/18
Computation of Income Tax Payable
Based on the Draft Accounts for the Financial Year Ended 31 March 2018

	Notes	Rs '000
Net profit before taxation (per accounts)		**137,642**
Add		
Provision for gratuity		12,990
Donations		1,750
Entertainment expenses		670
Depreciation		95,775
Advertisement / Business promotion		10,000
Royalty		-
Fall in value of investment property		1,399
Amortization of leasehold land		-
Amortization of intangible assets		6,860
Foreign travelling	1	1,680
Research expenses		-
Warranty provision		3,200
Impairment of related party receivables		24,068
Interest paid on the loan obtained to purchase shares of ET City Developers		100,000
Imputed interest cost relating to ET Electricals		20,000
Collective impairment for debtors (General provision)		25,000
		303,392
Less:	**Notes**	**Rs '000**
Dividend received		4,000
Writing back of service fees payable to ET Electricals		-
Royalty income		3,500
Reversal of provision for slow moving stock		2,470
Gratuity paid	2	3,420
Amortization of intangible assets for tax purposes at 10%	3	1,930
Depreciation allowances	4	53,900
Warranty claim		14,539
Interest from fixed deposits (Gross)		3,210
Interest from unlisted debt securities (Gross)		4,000
Writing back of loan provided by ET Electricals		2,583
		93,552

Adjusted profit for tax purposes		**347,482**
SUMMARY OF SOURCES OF INCOME		
Business profit		347,482
Royalty income		3,500
Interest income		7,210
Total statutory income		**358,192**
Less: Deduction from statutory income		-
Assessable income		**358,192**
Less: Qualifying payments		
Donation to approved charity		500
Taxable income		357,692
Income tax liability at 28%		100,154
Less: Tax Credits		
Quarterly SA payments made		13,564
WHT paid		721
Balance tax payable		85,869

Note 1 - Foreign Travel disallowed		
Foreign Travel		2,000
Less: Cost related to Joint Venture partners travel disallowed		800
Foreign Travel relates to ETD PLC		1,200
Profit adjusted for tax purpose of the previous year	16,000	
2% of above - 26 (1) (c) (B)		320
Amount allowed (whichever is lower)		320
Balance disallowed		880
Total disallowed		**1,680**

Note 2 - Gratuity paid	
Opening balance As At 01/04/2017	149,770
Add: Provision for the year	12,990
Total	162,760
Closing balance As At 31/03/2018	159,340
Gratuity paid	3,420

Note 3 - Amortization of intangible asset (Tax purposes)	
Opening balance as at 1 April 2017 (Book WDV)	37,490
Add: Additions during the year	8,000
Less: Amortization (Accounting) at 20%	(6,860)
Closing balance as at 31 March 2018 (Book WDV)	38,630
Amortization (Accounting) at 20%	6,860
Less: applicable to ET Electricals	**3,000**
Balance at 20%	3,860
Amortization of intangible assets for tax purposes at 10%	1,930

Note 4 - Depreciation Allowance				
Description	**Year**	**Cost**	**Rate**	**Amount**
		LKR	**%**	**LKR**
Depreciation allowance for the year 2016/17				**7,900**
Add: Depreciation allowance on additions during the year 2017/18				
Building		140,000	10%	14,000
Generators		30,000	33.33%	10,000
Motor Vehicles (Lorries and Motor cycles)		50,000	20%	10,000
Locally purchased software		12,000	100%	12,000
				53,900

(b) 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 those specifically disallowed under Section 26), are allowed as deductible expenses.

(i) Renovation and structural modification cost of a building owned by the company, which was incurred to bring it to a usable/operational condition as a Show Room, is considered Capital Expenditure on which depreciation could be claimed, for tax purposes. Hence the Repair Cost is not deductible for Corporate Tax purposes. Please refer Low Shipping Co Ltd VS CIR where it was held that Repairs deemed necessary at the time of purchase to render the subject matter of purchase usable, was a capital charge, which could be added to the initial cost, and that such cost could not be deducted in computing Profit and Income. ETD PLC could not have used the building, as a Show Room, without carrying out the required repairs and improvements. Hence it is capital charge. As per the case "Theobald vs Commissioner of Income Tax" it was held that any expenditure incurred which would result in 'enduring benefit', is of capital nature. Also, in terms of Section 26 (i) the cost of any improvements effected, is not allowed.

Accordingly, the position taken by the Assistant Commissioner is correct.

(ii) In terms of Section 25 (d) repair costs incurred, on a building which has been rented out by a company, can be deducted, subject to a limitation of twenty-five per centum of the gross rent receivable by such company for such premises. The company can therefore claim Rs. 240,000 (80,000 x12 x 25%) whereas the balance of Rs. 110,000 (350,000 – 240, 000) is disallowed.

Accordingly, the position taken by the Assistant Commissioner is partly incorrect.

(iii) The Cash loss of Rs 700,000 is claimable. The outgoings incurred in the course of business which are reasonable and commercially justifiable, can be deducted for tax purposes. The word 'outgoing' includes voluntary payments as well as involuntary outgoings, such as thefts, natural disaster etc.

In the case of "Hayley and Co Ltd vs the Commissioner of Inland Revenue" where the Company lost a large sum of money kept for the purpose of purchasing rubber, due to theft, it was held that the cash loss incurred was allowed as a deduction, for income tax purposes, on the following grounds.

- What is allowable for income tax is not only an expense, even outgoings are allowable. (The word outgoing is wide enough to cover losses if such outgoing is incurred in the production of income),
- Outgoing should be incurred in the production of income,
- The loss represents working capital and not fixed capital, and is therefore not capital expenditure. (It was held that such loss was out of circulating capital of the company and that the loss was incurred in the exercise of some step that had to be taken in conducting the Company's business, and that it must be regarded as a casualty or a misfortune incidental to the company's business. The judge observed that the money in the safe was intended to replenish stock in trade and therefore its loss would be equivalent to a loss of stock-in-trade. Hence, the loss incurred was incidental to the business and any commercial undertaking would deduct such loss from its income in order to ascertain its net profit.)

Therefore, the cash loss of Rs. 700,000 should be allowed as a deduction, as an involuntary outgoing incurred in the production of income.

The position taken by the Assistant Commissioner in this regard is incorrect.

(c) The regulation issued by the Tax Authority under Extra Ordinary Gazette No 1857/8 dated 9 April 2014 on adoption of Sri Lanka Accounting Standards, relating to the given entries/transactions, are set out below.

- Actuarial gain or loss – as per LKAS 26 - Any actuarial gain or loss charged to the Other Comprehensive Income (OCI) shall be disregarded.
- The tax computation is based on the Profit before Tax (PBT) and the OCI adjustments made after the PBT.
- Interest free loans given to employees (LKAS 19) - The benefit of interest free loans shall be taxed in the hands of employees.
- For this purpose, the benefit should be calculated based on the effective interest rate (EIR) as disclosed in the Financial Statement.

- The benefit associated with the special discount given to employees in respect of electrical goods distribute by the Company (LKAS 19) should be taxed in the hands of the employees.

- Share based payments (SLFRS 2) - As per the standard, goods/ services are to be recognized at the current market value and the impact on shareholders fund has to be shown.

- The share option cost charged to the Statement of Comprehensive Income (SOCI) is allowed in the hands of the employer, at the point of allotment, to the extent of the amount considered as benefit to the employee.

(d) Based on the given information, the following activities or areas of ETD PLC may have an exposure to Transfer Pricing:

- ETD PLC purchased all the goods manufactured by ET Electricals (Pvt) Ltd on two years 'interest free credit' terms.

- Imported goods were sold to the market at cost plus 30%, whereas similar type of goods purchased from ET Electricals (Pvt) Ltd, were sold keeping only a 10% markup, allowing ET Electricals (Pvt) Ltd which is exempt from tax, to keep a higher mark up.

- Common cost has been allocated among the Subsidiaries and Associates at a nominal fee and no expenditure has been allocated to ET Electrical (Pvt) Ltd for the year, though they have consumed the common facilities.

- It appears no fee has been charged from ET Electricals (Pvt) Ltd for subletting the manufacturing license, which belongs to ETD PLC.

- Any other activities carried out with related parties, including the transactions with Health Care (Pvt) Ltd.

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 ET Electricals is a Fully Owned Subsidiary of ETD PLC, 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). Also, in order to support that the related party transactions are carried out at ALP, both companies or one of the companies (tested party) has to maintain the information and documents specified by regulation 12, provided the aggregate value of the transactions entered into with the other associated undertaking exceeds Rs 50 million.

No corresponding adjustments allowing any deductions are allowed, as per regulation 14.

(Total: 50 marks)

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