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THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KB3 – Business Taxation and Law

December 2018

SECTION 1

BUSINESS LAW

Answer 01

(a)

Relevant Learning Outcome/s: 1.2.2
Explain the characteristics of a company.
Study text reference: Pages 7 – 9
Companies Act reference (for common seal): Section 12

General characteristics of a company

(Candidates are expected to briefly explain the characteristics)

Separate legal personality

Under company law, subsequent to incorporation, a company becomes a separate legal personality compared to its members. In other words, the company is distinct and different from its members in the eyes of the law. It has its own seal and its own name, and its assets and liabilities are separate and distinct from those of its members. It is capable of owning property, incurring debt, borrowing money, employing people, having a bank account and entering into contracts.

Capacity to sue and be sued

A company can sue or be sued in its own name distinct from its members. Thus, members are not named as parties in a case when a company institutes action or is sued by a third party.

Limited liability

Limited in effect means that the liability of the members of the company (namely the contribution a member will have to make if the company is being wound up) is limited to the contribution made to the assets of the company, up to the face value of shares held by the member. A member is liable to pay only the uncalled money due on shares held by him/her.

Perpetual succession

A company does not cease to exist unless it is specifically wound up or the task for which it was formed has been completed. Membership of a company may keep on changing from time to time but that does not affect the life of the company. Insolvency or death of a member does not affect the existence of the company.

Separate property

A company is a distinct legal entity. The company's property is its own and such ownership is independent of the members of the company. A member cannot claim to be the owner of the company's property during the existence of the company. When a company is wound up, its assets would be sold to settle its creditors.

Transferability of shares

Shares in a company are freely transferable, subject to certain conditions, such that no shareholder is permanently or necessarily wedded to a company. When a member transfers his/her shares to another person, the transferee steps into the shoes of the transferor and acquires all the rights of the transferor in respect of those shares.

Separate management

A company is administered and managed by its managerial personnel i.e. the board of directors. The shareholders are simply the holders of the shares of the company and need not be necessarily the managers of the company. The shareholders own the company, but unless a shareholder is part of the board, such shareholder cannot be involved in the management affairs of the company. The role of management of a company is therefore exclusively the role of the directors.

Common seal

The common seal is the official signature of the company. The name of the company and its registered number must be engraved on the common seal. Therefore even if the directors are authorised to sign on behalf of a company, in practice, the seal of the company too is placed on contracts etc. Under the old Companies Act any document not bearing the seal of the company may not on occasion be accepted as authentic and may not have any legal force. But under the provisions of the new Companies Act however the mandatory requirement of attaching the company seal to documents has been relaxed. It is optional. Nevertheless in a practical sense the common seal is still used by most companies.

(b)

Relevant Learning Outcome/s: 4.1.1 and 4.1.2

4.1.1 Explain the following terms in relation to the directors of a company: appointment, retirement and removal, powers, duties and liabilities, civil and criminal liabilities.

4.1.2 Explain the division of power between directors and members.

Study text reference: Pages 71 and 72

(Candidates are expected to write the differences between an executive director and a non-executive director)

Executive director	Non-executive director
He is an employee of the company (i.e. he is a member of the executive team).	He is not an employee of the company (i.e. he is not a member of the executive team).
He is involved in the day-to-day management activities of the company.	He is not involved in the day-to-day management activities of the company.
He is paid a salary.	He is paid a director fee.
Executive director has a job designation.	He does not have a definite job designation. He is involved in policy planning/making exercises. He is involved in monitoring the work of the Executive directors.

(Total: 10 marks)

Answer 02

(a)

Relevant Learning Outcome/s: 2.3.1

Analyse the rights and duties of promoters, including liability for pre-incorporation contracts, with relevant cases.

Study text reference: Page 30

(Candidates are expected to briefly explain the duties that have been breached by the promoter in this instance)

In the given scenario Palitha, as the promoter, has breached the following duties:

- As Palitha did not disclose the profit he made from the land transaction to the company or its shareholder Alfred, it is clear that Palitha **made a secret profit**.

As the promoter, Palitha had a **duty not to have made any secret profit** out of this land transaction. Therefore he has **breached** this duty of his.

- Further Palitha also had a duty as the promoter to make a **full disclosure** to the company of all the relevant facts including any profit made by the promoter in transactions with the company. As he failed to do this, he has breached this duty as well.

(b)

Relevant Learning Outcome/s: 2.5.1

Explain pre-incorporation contracts, implied warranties and ratification.

Study text reference: Page 36

Companies Act reference: Section 25

(i)

(Candidates are expected to briefly state the orders that a court can make when a pre-incorporation contract is not ratified by the company)

In such a situation, a court may make an order:

1. directing the company to return the property acquired under the pre-incorporation contract, to that party or
2. validating the contract in whole or in part or
3. granting any other relief in favour of the innocent party (Tina) relating to the property acquired

(ii)

Relevant Learning Outcome/s: 2.5.1

Explain pre-incorporation contracts, implied warranties and ratification.

Study text reference: Page 36

Companies Act reference: Section 24

(Candidates are expected to briefly state the implied warranties in a pre-incorporation contract)

Hanifa is deemed to have given Tina the following implied warranties in the pre-incorporation contract:

- That the company will be incorporated within a reasonable time after making this contract.
- That the company will ratify this contract within a reasonable time after the incorporation of the company.

(Total: 10 marks)

Answer 03

(a)

Relevant Learning Outcome/s: 3.3.1

Analyse the following principles in relation to capital maintenance in a company (redemption, reduction of capital, financial assistance, share buy-back, minority buy-out).

Study text reference: Page 54

Companies Act reference: Section 59

(Candidates are expected to write the provisions of the Companies Act, relevant to the above scenario only)

Restriction and consent of the creditor

- Per the given scenario the company has already agreed in writing with the main creditor of the company that it will not reduce its stated capital below Rs. 75 million.
- Therefore if the company intends to go ahead with the proposed reduction of its stated capital to Rs. 50 million, it has to **first obtain the consent of the creditor for the reduction.**
- If the **consent is not obtained**, any **reduction** in the company's stated capital below Rs. 75 million will result in a breach of the agreement with the creditor, thereby making it **invalid and of no effect.**

- Once the **consent** of creditor is **obtained** the company is required to do the following in order to reduce its stated capital to Rs. 50 million.
 - Per Section 59, to reduce the stated capital a **special resolution must be passed by the company**.
 - However the company must give **public notice** of the proposed reduction of stated capital at least **sixty (60) days** before the passing of this special resolution.
 - Thereafter it has to **inform the Registrar within ten (10) working days of such reduction**, the amount of the reduction and the amount of reduced stated capital in the specified form.

(b)

Relevant Learning Outcome/s: 3.5.2

Outline the principles relating to “majority rule” and “minority protection” (including “Oppression, Mismanagement and derivative action and Major Transactions”) (S. 185 of the Companies Act).

Study text reference: Pages 60 and 68

Companies Act reference: Section 226

(Candidates are expected to analyse the given scenario in relation to Section 226 of the Companies Act)

According to **Section 226** of the Companies Act, a shareholder making the application for either oppression or mismanagement should hold shares during the six months prior to the making of the application which constitute not less than 5% of the total number of the shareholders or hold shares which together carry not less than 5% of the voting rights at a general meeting of the company.

No. of ordinary shares with voting rights held by S in HPL = 5

Total no. of ordinary shares with voting rights issued by HPL = 500

Therefore the % of voting rights held by S in HPL = $5/500 * 100\% = 1\%$

Total no. of shareholders of HPL (including S) = 4

Therefore, as a % of the total no. of shareholders of HPL, S constitutes 25% (i.e. $\frac{1}{4} * 100\%$)

Thus when considering S’s eligibility under the Companies Act to file an application to court for oppression or mismanagement, it is seen as follows.

- Even though S does not hold the stipulated minimum of 5% of the voting rights in HPL, he constitutes for more than 5% of the total no. of shareholders of HPL.

Hence S has satisfied the 1st requirement under Section 226.

Further per the given scenario S has held these shares for the last one (01) year, and there had been no change in the shareholding of HPL during that year.

- This means that S has satisfied the 1st criteria above for more than the stipulated minimum of 6 months. Hence S has satisfied the 2nd and final requirement under Section 226.

Therefore it is clear that it is possible for S to file action in a court for oppression or mismanagement under the Companies Act.

(Total: 10 marks)

Answer 04

(a)

Relevant Learning Outcome/s: 5.1.1

Compare and contrast the different types of meetings in a company, and their purposes and notice periods.

Study text reference: Page 98

XYZ (Pvt) Ltd

Minutes of the Annual General Meeting of XYZ (Pvt) Ltd held on 30 September 2018 at 4.30p.m. at "The Race Course".

Present:

Rose (Chairman)

Aruna

Namal

Minute No. 1 – Audited accounts for the financial year ended 31 March 2018

The audited accounts for the financial year ended 31 March 2018 were tabled and approved by the shareholders, with Aruna proposing and Namal seconding.

Minute No. 2 – Re-appointment of auditors

ABC Associates was re-elected unanimously as the company's auditor for the financial year 2018/19. This was proposed by Rose and seconded by Aruna.

Minute No. 3 – Dividends for the financial year 2018

In the absence of profits, the shareholders unanimously agreed not to declare a dividend.

There being no other business the meeting was adjourned at 5.00pm.

CONFIRMED AS CORRECT

Chairman

(b)

Relevant Learning Outcome/s: 6.2.1

Outline the functions of administrator/liquidator and receivers/managers.

Study text reference: Page 122

Companies Act reference: Section 291

(Candidates are required to write the provisions of the Companies Act in relation to the vesting of property of company on liquidator)

Chandika must do the following in order to vest the company's property in his name as the liquidator:

- When a company is being wound up by court, Chandika must make an application to court and get a court order.
- The nature of this order must be such that it directs all or any part of the property of whatever description belonging to the company or held by trustees on its behalf, shall vest in the liquidator in his official name.
- Once the order is received, the property to which the order relates to shall vest in the liquidator accordingly.

(Total: 10 marks)

Answer 05

(a)

Relevant Learning Outcome/s: 7.1.2

Explain transfer of listed securities via CSE.

Study text reference: Pages 143 and 144

(Candidates are expected to give a brief explanation)

- (i) The ownership of the shares will get transferred to Malik's wife (as his nominee) only upon his death.
- (ii) The following procedure must be followed in order to gift the shares as detailed in the scenario:
 - Malik's son has to first open a client account at the Central Depository System (CDS).
 - Thereafter in order to gift these shares, the approval of the Securities and Exchange Commission (SEC) must be obtained.
 - After paying the applicable government stamp duty Malik can gift the shares to his son.

(b)

Relevant Learning Outcome/s: 8.3

Arbitration

Study text reference: Pages 162 and 163

(Candidates are expected to write the components only)

Some of the main components of an arbitration clause are:

- it should set out the procedure that is to be followed in setting up the arbitration tribunal
- the number of arbitrators
- the language in which the arbitration is to be conducted
- the relevant law upon which the arbitration will be adjudicated
- the procedure to be followed in conducting the arbitration
- the venue of the arbitration
- it should refer to any dispute in connection with the contractual relationship between the parties.

(Total: 10 marks)

SECTION 2 BUSINESS TAXATION

Answer 06

Relevant Learning Outcome/s: 1.2 and 2.1
1.2 Taxable income of a company
2.1 Dividend tax

(a)

Ride & Race (Pvt) Ltd Income tax computation for the year of assessment 2018/19

	Rs.
Business income (Note 1)	30,728,000
Investment income	
Dividend income – exempt (3 rd schedule)	-
Interest income from fixed deposit	4,000,000
Assessable income	34,728,000
Less: Qualifying payments and relief:	
Donation made to the government – full cost can be claimed	(4,900,000)
Taxable income	29,828,000
Tax liability at 14 % – Exports > 80% of total income	4,175,920
Tax credits	
Economic Service charge (ESC)	(3,184,000)
WHT tax on interest Income	(200,000)
Self Assessment payments	(250,000)
Balance tax payable	541,920

Note 1: Computation of assessable income from trade/business

	Rs.	Rs.
	+	-
Net profit before tax	31,490,000	
Less: Investment income		
Interest income – fixed deposit (gross)		4,000,000
Dividend income (net) – exempt		3,000,000
Add/less		
Exchange gain – taxable – no adjustment		-
Book depreciation – disallowed U.S 10	8,235,000	
Staff training – allowed		-
Book loss on asset disposal	1,000,000	
Balancing allowances/assessable charge on disposed asset		
Sale proceeds – (cost – depreciation allowance)		
13,500,000 – (15,000,000 – 0) = 1,500,000		1,500,000
Gratuity provision – disallowed – U.S 10	250,000	
Research expenses – no adjustment	-	
Additional research and development temporary concession (100% of expenses)		3,700,000
Advertising cost incurred to find land – disallowed – U.S 11	40,000	
Advertising done in foreign media – allowed – U.S 11		-
Foreign travelling – allowed – U.S 11		-
Entertainment – disallowed – U.S 10	320,000	
Donation disallowed and claimed as a qualifying payment	4,900,000	
Capital allowances		
Land – not allowed to claim capital allowances		
Plant and machinery (25,200,000 – 15,000,000) = 10,200,000 → 5 years		2,040,000
Motor lorry – 5,100,000 → 5 years		1,020,000
Office furniture – 1,235,000 → 5 years		247,000
Building – WIP – cannot claim since it is not used		-
	46,235,000	5,507,000
Assessable income from trade or business	30,728,000	

- (b)
- | | | |
|-----|---|-------------|
| (i) | Dividend distribution made | 4,800,000 |
| | Less: Dividend distributed out of dividend received | (3,000,000) |
| | Net dividend | 1,800,000 |
| | WHT @14% | 252,000 |
- (ii) Dividend tax has to be paid within 15 days after the end of the calendar month of which the tax is withheld (i.e. on or before 15 February 2019).

Answer 07

Relevant Learning Outcome/s: 5.1.3, 5.1.4, 5.1.5, 5.1.6, 5.2.3, 5.2.4, 5.4.1, 5.4.2, 3.1.2, 1.2, 4.1.1

- 5.1.3 Assess monthly/quarterly tax payable, taking into account the output tax and input
- 5.1.4 Apply knowledge on a given set of exempted supplies, in computation of output tax and claimable input tax.
- 5.1.5 Outline the concept of simplified VAT and eligibility for registration under the scheme.
- 5.1.6 State due dates of payment, furnishing returns and provisions applicable to refunds.
- 5.2.3 Compute NBT payable by a business of manufacturing, service, wholesale, retail or distributor.
- 5.2.4 Apply the knowledge on excepted articles and services into the computation of NBT payable by a business.
- 5.4.1 State the liable instruments and respective rates of stamp duty, under the Stamp Duty (Special Provisions) Act.
- 5.4.2 Identify the instruments liable for stamp duty payable to Provincial Councils.
- 3.1.2 Assess the tax payable by a partnership, due dates of payment and the tax credit available to partners
- 1.2 Taxable income of a company
- 4.1.1 Outline the mandatory requirement of a person carrying on a trade, business, profession or vocation to register with the Commissioner General of Inland Revenue.

(a) (i)

		Amount Rs.		Amount Rs.
Output tax				
Service exports – Zero-rated supplies (USD 21,000*170)		3,570,000	0%	-
Services provided to clients in SL	SVAT	1,225,000	15%	183,750
Services provided to clients in SL	Non SVAT	7,825,000	15%	1,173,750
Advance receipt (inclusive of VAT)		300,000	15%	45,000
		12,920,000		1,402,500
Input tax				
Office expenses				260,000
Furniture				24,000
Repairs to motor car				Not claimable
				284,000
Unclaimed brought forward input VAT				124,000
				408,000
Input tax claimable without restriction				
((Zero-rated supplies + SVAT supplies) x claimable input tax)/Total supplies				
((3,570,000 + 1,225,000) x 284,000)/12,920,000		=	105,400	
Balance subject to 100% of output tax on taxable supplies 1,218,750 or 302,600 →			302,600	
Total input tax claimable				(408,000)
VAT payable				994,500
SVAT credit vouchers				(183,750)
Instalments paid				(500,000)
Balance VAT payable				310,750

(ii) Due dates of payments

Period due date	
01.07.2018 – 15.07.2018	31.07.2018
16.07.2018 – 31.07.2018	15.08.2018
01.08.2018 – 15.08.2018	31.08.2018
16.08.2018 – 31.08.2018	15.09.2018
01.09.2018 – 15.09.2018	30.09.2018
16.09.2018 – 30.09.2018	15.10.2018

(iii)

Per Section 22 (6) (iv) (a), input tax can be deducted from output tax for any taxable period ending on or before the expiry of twelve (12) months from the date of such tax invoice.

Accordingly, input tax pertaining to this invoice can be claimed on or before 2 June 2019 (QE 30.06.2019)

(iv)

	Rs.		Rs.
Received for services provided to Indian client	3,570,000	-	Exempted
Payments received under SVAT	1,225,000	2%	24,500
Payment received from other clients	7,825,000	2%	156,500
Advance received			Not liable
NBT liability			181,000

(v)

	Rs.
Consideration received	9,500,000
Less:	
Cost of asset as at 30 September 2017	(8,750,000)
Advertisement charges	(82,000)
Capital gain	668,000
Tax @ 10%	66,800

(vi) The capital gains tax has to be paid not later than one (01) month after the realisation of the gain.

(vii) The land sale is liable to stamp duty. First Rs. 100,000 at 3% and the balance amount at 4%.

(b)

(i) A person means an individual or entity, and includes a body of persons, corporate or unincorporated, an executor, non-governmental organisation and charitable institution.

(ii) The precedent partner, or in the absence of such partner in Sri Lanka, an agent of the partnership in Sri Lanka, shall withhold tax in accordance with Section 84 of the Act and at the rate (8%) provided for in paragraph 10 of the First Schedule to the Act on each partner's share of any partnership income, excluding capital gains [Section 84 (1) (a) (ii)], if any.

(Total: 25 marks)

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