THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC 3 - Corporate Taxation

December 2019

Answer 01

Relevant Learning Outcomes: 2.1/2.2/2.3/ 6.4

(a) The Inland Revenue Act No. 24 of 2017 ("IRA") in section 69(4) provides the criteria that need to be satisfied in order for a company to be considered a "resident" for income tax purposes. As PureH2O (Pte) Ltd is a company incorporated outside Sri Lanka it will be considered a non-resident for income tax in Sri Lanka as it does not satisfy the criteria set out in section 69(4) of the IRA.

In terms of section 4(b) of the IRA, assessable income of a non-resident person is equal to the persons income from employment, business, investment or any other source for that year of assessment, to the extent that the income "arises in or is derived from a source in Sri Lanka". Based on the information provided, PureH2O (Pte) Ltd has derived business income from a source in Sri Lanka.

Sri Lanka has entered into a Double Tax Avoidance agreement ("DTA") with Singapore. According to Article 5(3) of the DTA, a Permanent establishment ("PE") is created in the following instances;

"3. The term "permanent establishment" also encompasses:

(a) a building site, a construction, assembly or installation project, a drilling rig or ship used for exploration or development of natural resources, including supervisory activities in connection therewith, but only if such site, project or activities lasts for a period of more than 183 days within any 12-month period;

(b) the furnishing of services, including consultancy services, by an enterprise of a Contracting State through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within the other Contracting State for a period or periods aggregating more than 183 days within any 12-months period."

Based on the information provided, no employees of PureH2O (Pte) Ltd had visited Sri Lanka as all the design and delivery of building material were being handled directly from Singapore. As such PureH2O (Pte) Ltd will not be creating a PE under the sections quoted above.

However, Article 5 (7) provides;

"7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are imposed by that enterprise on the agent in their commercial and financial relations, which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph."

Based on our understanding, PureH2O Lanka (Pvt) Ltd is a wholly owned subsidiary of PureH2O (Pte) Ltd and is engaged in providing services in relation to projects undertaken

by PureH2O Singapore. As such where activities of PureH2O Lanka are devoted wholly or almost wholly on behalf of PureH2O (Pte) Ltd, then the Sri Lankan entity would be considered a dependent agent of PureH2O (Pte) Ltd. Therefore, PureH2O (Pte) Ltd will be deemed to have a PE in Sri Lanka.

As PureH2O (Pte) Ltd is deemed to create a PE in Sri Lanka it, will be liable to pay income tax in Sri Lanka, based on Article 7 of the DTA on the profits that are attributable to the PE in Sri Lanka.

(b) Article 7 of the DTA provides,
"1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only on the portion that is attributable to that permanent establishment."

According to Article 7 (1) of the DTA, PureH2O (Pte) Ltd is only liable to pay income tax in Sri Lanka, on the profits that are attributable to the PE in Sri Lanka. (1 mark) As the supply and delivery of material is directly done by PureH2O (Pte) Ltd in Singapore, profits from such activities are not attributable to the PE in Sri Lanka. As such the income/profits from such activities will not be subject to income tax in Sri Lanka.

In the case of *Anglo-Persian Oil Co. v CIT* (1 mark) the appellant company was incorporated in England and carried on business there. It produced and sold fuel oil. It entered into contracts in London with ship owners whose ships call at various ports including Colombo. In Colombo the Appellant company had no place of business but stored its fuel oil with its agent the Ceylon Company which trades in fuel oil. The payment is to be made in London. The Ceylon Company stores the appellant's oil and its own oil in tanks built on premises used by the Ceylon company for its own business. It was held in this case that the property in the goods passed to the shipping company at the time the contract was signed, and that the Ceylon Company was merely an agent for the delivery of the oil. The act of delivery of the oil in Ceylon, does not bring the profits under the classification of "profits arising in or derived from Ceylon". If the agent in Ceylon did not actually affect the contract, or if he was not instrumental in affecting it, the non-resident would not be liable from the profits arising on such transactions.

Based on the above case, the transactions on delivery of material by the Singapore company were entered in Singapore. Further, the local entity was not instrumental in affecting such transactions. As such, the profits on these transactions will not be liable to income tax in Sri Lanka.

(c)

		LKR
Income	500,000 x 175	87,500,000
Less:		
Related expenses	(345,000+23,000) x 175	(64,400,000)
Assessable Income from business		23,100,000
Taxable income		23,100,000
Income tax payable	23,100,000 @ 28%	**6,468,000**
Balance		16,632,000
Remittance tax payable	16,632,000 @ 14%	**2,328,480**

(d)

(i) Section 195 of the IRA (0.5 mark) defines an Approved Accountant as "an accountant who is a member of the Institute of Chartered Accountants of Sri Lanka." As Mr. Perera is a Chartered Accountant, he will be considered as an Approved Accountant under the IRA.

(ii) Section 126(5) of the IRA specifies that where a return or part of a return was prepared for a reward by some other person, including by an Approved Accountant, other than a full time employee of the taxpayer, that other person shall also sign the return. As Mr. Perera is an employee of PureH2O Lanka (Pvt) Ltd he is not required to sign the Return even though he has prepared the Return.

However, section 126 (4) specifies that the taxpayer's duly authorized agent shall sign the return. The definition of "authorized representative" in section 195 includes a member of the Institute of Chartered Accountants of Sri Lanka. (0.5 mark)Therefore if PureH2O Lanka (Pvt) Ltd has duly appointed Mr. Perera as its Authorised agent, then he will be required to sign the tax Return.

Answer 02

Relevant Learning Outcomes: 4.1/ 4.3, 6.4, 3.1/3.2

Marine Support (Private) Limited							
TIN:123456789 7000							
CALCULATION OF VAT							
For the quarter ended 31 June 2019							
	Turnover	**Exempt**	**Excluded**	**Liable**		**VAT**	**Remarks**
	Rs.			**0%**	**15%**		
Agency fees received from shipping line	1,400,000			1,400,000			Gazette No 1267/5 of 17-12-2002
Crew change/recruitment services	3,100,000			3,100,000			Gazette No 1267/5 of 17-12-2002
Supply of stationery	740,000			740,000		-	Gazette No 1267/5 of 17-12-2002
Laundry services	260,000			260,000		-	Gazette No 1267/5 of 17-12-2002
Agency fee from Marine Security Inc	1,150,000				1,150,000	172,500	
Reimbursement of expenses by Marine Security Inc.	750,000				750,000	112,500	
Interst Income	-		325,000				
Rent income – car park	750,000	750,000				-	Supply made to a Diplomatic mission - exempt
Rent income - office	-	-				-	Invoiced in January 2019
	8,150,000	**750,000**	**325,000**	**5,500,000**	**1,900,000**		
Total output tax						**285,000**	
Input							
On Imports (All relates to liable supplies)		90,500					
On Local Purchases		54,000					
Total		144,500					
Less: Input tax relating to exempt supplies							
Input tax directly attributable to the car park		(18,000)					
Common Input tax relating to exempt income (proportionate)		(3,313)					
(54,000-18,000)/8,150,000x750,000							
Input tax claimable		123,187				**(123,187)**	
VAT liability for the Q/E 30 June 2019						**161,813**	
Tax Credits							
Advance payments made						(45,000)	
VAT payable /(refund)						**116,813**	

(a) Internal memorandum

To Financial Controller of MSPL,

Penalty on late payment of VAT

All registered persons other than manufactures are required to pay VAT on a bi-monthly basis. i.e. VAT payable for the period from the 1st to 15th day of the month, on or before the end of the month and for the period from 16th to the end of the month, on or before 15th of the subsequent month. (Section 26(1A))

Since, MSPL has discharged its VAT liability only on a monthly basis, MSL is liable to penalties as follows. (section 27(1)) (0.5)

- The penalty for non-payment on the due date - 10% of the tax in default; and
- If, the default tax is not paid by end of the succeeding month, a further penalty of 2% is added for each month or part thereof which is in default.
- However, the total penalty will not exceed 100% of the tax in default.

Time bar provision to issue a VAT assessment

If MSPL has filed the VAT return for the quarter ended 31 March 2016 on time (by 30 April 2016), time bar period to raise an assessment or an additional assessment operates after 3 years from the end of the quarter (i.e. 31 March 2019) (section 33(1)).

However, if the Return has not been filed on the due date, this time bar provision will not apply.

In case, MSL has filed the VAT return on time, the assessment is not valid and MSL can appeal on this ground.

(b) Applicability of Withholding Tax

In terms of section 73 (1)(h) payments received by a person who conducts a relevant transport business in respect of the carriage of passengers who embark or cargo, mail or other moveable tangible assets that are dispatched from Sri Lanka (outward freight), other than as a result of transshipment by sources in Sri Lanka.

Section 85(2) of the Inland Revenue Act stipulates that regulations may be made prescribing the type of services from which withholding tax (WHT) is deductible, inclusive of the rate at which such tax shall be withheld;

"---, regulations may be made prescribing -

(a) that a resident person shall withhold tax when the person makes a payment to a non-resident person of a type referred to in paragraph (h) or (i) of section 73 (land, sea or air transport or telecommunication services); and

(b) the rate at which the tax referred to in paragraph (a) shall be withheld."

Accordingly, regulations have been made in the Gazette No. 2064/51 (effective from 1 April 2018), prescribing a WHT rate of 2%.

Accordingly, the payments made by MSPL on account of outward freight to the Principal is subject to WHT at 2% at the time the payment is made. (1 mark)

The taxes withheld shall be remitted to DIR on or before the 15th of the following month. The Company as a Withholding Agent is required to file an 'Annual Statement" along with relevant schedules and information with the DIR on or before 30th April 2019 for the periods commencing 1 April 2018.

Penalty

If the company fails to pay tax within fourteen days of the due date, the company will be liable to a penalty equal to 20% of the tax due (tax-in-default) (section 179).

In addition, interest on the amount of tax not paid by the due date at the rate of 1.5% per month or part of the month, will be compounded monthly. (sections 157 and 159)

Question 03

Relevant Learning Outcomes: 4.1/ 4.3, 6.4, 3.1/3.2

(a)

UPCOUNTRY ESTATE PVT LTD
Year of Assessment 2018/2019
Computation of Income Tax Payable
Based on the Unaudited Accounts for the Financial Year Ended 31 March 2019

COMPUTATION OF ASSESSABLE INCOME FROM TRADE / BUSINESS	**Notes**	**Rs '000**
Net profit before taxation (per accounts)		**178,924**
Add:		
Assessable Charge/ Profit from disposal of property plant & Equipment (Tax)	**1**	5,500
Provision for obsolete stock		4,500
Provision for gratuity	**2**	75,000
Legal fees (Disallowed since capital nature)		4,900
Depreciation - Freehold/ Leasehold Property Plant & Equipment (Accounting)		116,000
Amortization - Mature/ Immature plantation		111,737
Leasehold right to bear land-(No adjustment needed since amortisation is based on actual period - 4th Sch)		-
Immovable lease assets-(No adjustment needed since amortisation is based on actual period - 4th Sch)		-
Advertisement & Business Promotion(Allowed since all expenses are Incurred in production of Income)		-
Write off of an amount due from a related party (Disallowed since not Incurred in production of Income)		30,450
Donation made to President's Fund		3,000
Disallowed interest expenses under section 18	**3**	-
		351,087
Less:		
Amortization of Capital Grant -(Accounting)		10,045
Fair value gain on consumable biological assets-(Accounting)		88,767
Profit from disposal of property plant & Equipment (Accounting)		5,500
Rent Income - Taxed as investment income		7,100
Dividend income (net)		20,500
Gratuity paid	**2**	5,110
Research And Development - 100% additional deduction - 6th schedule		3,800
Research And Development -capital expense on Machinery - ' allowed under section 15		12,500
Research And Development - Machinery Cost -100% additional deduction - 6th schedule		12,500
Additions to immature plantations		280,000
Unrealized Exchange gain (conversions as at 31-3-2019)		14,800
Interest income from Fixed deposits (gross)		14,550
Interest income from treasury bills-invested during the year		18,504
Depreciation allowances	**4**	68,575
B/F tax loss		14,200

		576,451
Assessable income/(loss) from Business		**(46,440)**
COMPUTATION OF TAXABLE INCOME		
Assessable Income from Business		-
Assessable Income from Investment		
Rent Income	7,100	
Interest income from Fixed deposits (gross)	14,550	
Interest income from treasury bills-invested during the year	18,504	
		40,154
TOTAL ASSESSABLE INCOME		**40,154**
Less: Trade Loss Transferred from Business		(40,154)
TOTAL ASSESSABLE INCOME AFTER CLAIMING LOSSES		**-**
Less: Qualifying payments & Relief		
Donation made to Sevena Fund		**-**
TAXABLE INCOME		**Nil**
Income tax payable		**Nil**
Less: Tax Credits		
WHT paid	**5**	1,438
Installment payments made		575
ESC paid (c/f to the year 2019/2020 - Rs. 19,425,000)		-
		2,013
Income Tax Over Paid- refund due		**2,013**
TRADE LOSSES FROM BUSINESS		
Assessable Loss from Business		46,440
Less: Transferred to set off against Investment Income		(40,154)
Trade Loss carried forward to the Y/A 2019/2020		**6,286**

		Rs '000	Rs '000	Rs '000	Rs '000	Rs '000		
Note 1- Balancing allowance/assessable charge on Disposal of Fixed Assets								
Description	**Year of purchase**	**Cost**	**Tax Depn claimed**	**Tax WDV**	**Sales Proceed**	**Taxable Profit**	**Years**	**rate**
Plant and machinery – Freehold	2013/14	7,500	7,500	-	5,500	5,500	6	33.33%
Tax (Loss)/gain on Disposal of Fixed Assets						**5,500**		
Note 2 - Gratuity Paid								
Opening balance As At 01/04/2018				690,888				
Add: Provision for the year				75,000				
Less : Actuarial Loss				(213)				
Total				765,675				
Closing balance As At 31/03/2019				760,565				
Gratuity Paid				**5,110**				
Note 3 - Disallowed interest expenses								
Bank loan interest				452,000				
Bank Overdraft interest				48,000				
	A			**500,000**				
Interest bearing borrowings -NC				2,200,303				
Interest bearing borrowings -C				925,433				
Bank overdraft				455,675				
	B			**3,581,411**				
Share Capital				600,000				
General Reserves				250,000				
Retained Earnings				2,848,100				
				3,698,100				
Three times of the above	C			11,094,300				
Finance Cost	A			500,000				
Financial instrument value	B			3,581,411				
Maximum interest claimable	D=(A/B*C)			**1,548,873**				

Note 4 - Depreciation Allowance								
Description	**Year**	**Cost**	**Years / %**	**Amount**				
		Rs '000		**Rs '000**				
Depreciation allowance for the year 2017/2018				52,700				
Add: Depreciation allowance on additions during the year 2018/19								
Intangible Asset - (Manufacturing Licence for 10 Yrs. - V	2018/19	4,000	10	400				
Buildings and structures	2018/19	13,500	20	675				
Plant and machinery – Freehold	2018/19	37,500	5	7,500				
Plant and machinery – Leasehold	2018/19	36,500	5	7,300				
		91,500		**15,875**				
Less: Depreciation allowance on disposals during the year 2018/19								
Plant and machinery – Freehold	2013/14	7,500,000	33.33%	-				
Less: Depreciation allowance on assets which were fully depreciated during the year 2017/18				**-**				
Depreciation allowance for the year 2018/19				**68,575**				
Note 5 - WHT paid at source								
Rent Income		7,100	10%	710				
Interest income from Fixed deposits (gross)		14,550	5%	728				
Interest income from treasury bills-invested during the year		18,504	0%	-				
				1,438				

(b) (i) The Inland Revenue Act No. 24 of 2017 provides a lower rate of 14% to agricultural business.

Agricultural business means the business of producing agricultural, horticultural or any animal produce and includes an undertaking for the purpose of rearing livestock or poultry.

Therefore, if UEL operates "tea shops" the tax rate of 14% will be applicable to UEL, subject to the predominant rule.

However, if UEL incorporates a separate company, that company will be taxed at the rate of 28%.

The new company is to be eligible for the lower rate of 14% as a Small / Medium Enterprise, the following conditions must met.

a) The business is to be conducted solely in Sri Lanka
b) The person does not have an associate, that is an entity
c) The person's gross annual turnover must be less than Rs. 500 million

The term 'associate' has been defined in section 196.
According to the said definition, the new company will not be entitled to the lower rate of 14% under the SME category since the new company will have an associate which is an entity.

The Sixth Schedule to the Inland Revenue Act No. 24 of 2017 provides for enhanced capital allowances (temporary concession for a period of 3 years) as detailed below in addition to the normal capital allowances set out in the Forth Schedule for investments below USD 3 Million.
"A capital allowance of 100% for expenses incurred by a person on depreciable assets, where such assets are used in a part of Sri Lanka other than a Northern Province (Jaffna)."

Depreciable assets are class 1 and class 4 assets within the meaning of paragraph 1 of the Fourth Schedule comprising plant and machinery that are used to improve business processes or productivity and fixed to the business premises.

However, these enhanced capital allowances are not available in relation to the expansion of an existing business. If UEL incorporates a new company in Sri Lanka to make the investment in sales outlets, that company would be eligible to this concession as the question of "whether this is an expansion of an existing business?" may not arise.

(ii) Disposal of private company shares are liable for capital gains tax in the hand of the seller as follows-

Capital gains Tax = (Consideration Less Cost) x 10%

Accordingly, if the shares are disposed of now, the Chairman and his son will be liable to capital gains tax if there is a gain from realization of the shares.

However, as per the Third Schedule to the Inland Revenue Act No. 24 of 2017 the on realization from sale of shares quoted in any official list published by any stock exchange licensed by the Securities and Exchange Commission is exempt from capital gains tax.

Accordingly, capital gains tax will not be applicable if the UEL is listed with the Diri Savi Board of the Colombo Stock Exchange. Therefore it is advisable to dispose of shares once the company is listed in the Diri Savi Board of the Colombo Stock Exchange.

(c) In terms of section 85 and the First Schedule of the Inland Revenue Act No. 24 of 2017 a person is required to withhold tax at the rate of 5% on amounts exceeding Rs. 50,000 where such person pays a service fee with a source in Sri Lanka to a resident individual (who is not an employee).

These service fees include the following:

a) commission or brokerage to a resident insurance, sales or canvassing agent;
b) in relation to the supply of any article on a contract basis through tender or quotation;
c) any service as prescribed by Gazette No. 2064/51

Accordingly, if UEL pays fees for any of the above listed services to any resident individuals UEL will be statutorily obliged to withhold taxes at the time of payment.

If the total payment (excluding VAT) made to an individual is less than Rs. 50,000 per month, there will be no requirement to withhold taxes on such payment/s.
However, even if the service fee exceeds Rs. 50,000 per month, there will be no requirement to withhold tax on such payments in the following circumstances.

- Payments or allocations that are exempt amounts
- Payments of specified fees in respect of which a certificate is presented by the recipient person confirming that the payments are chargeable with the Economic Service Charge (ESC) under the Economic Service Charge Act, No. 13 of 2006.

Accordingly, if the recipient is either exempted from income tax on the income (under Section 9 of the Act) or is chargeable with ESC as envisaged above, the recipient can obtain a certificate from the IRD confirming that the recipient is eligible for such exemption/ chargeable with ESC. If such a certificate is produced to UEL, there will be no requirement for UEL to withhold taxes on the payment of service fee. If no such certificate is provided by the recipient, UEL must withhold tax at the rate aforementioned in order to deduct such payments/expenses for tax purposes and to avoid any penalties.

(d) One of the objectives of transfer pricing legislation is to prevent the use of special relationships to reduce tax incidence and to ensure that related parties (associated enterprises) transact business at arms-length prices.

In terms of section 77(1) any income, gain or profits arising in, derived or accruing from, or any loss incurred by any person in Sri Lanka engaged in any domestic transaction, entered into with its associated enterprises shall be ascertained having regard to the arm's length price.

In terms of section 77(5)(e) "Arm's Length Price" means for the purpose of ascertaining income, gain or profits arising in, derived or accruing from or losses incurred in any

transaction, operation or scheme entered into between two associated enterprises calculated in accordance with the arm's length principle, as that where a connected transaction is carried out taking into account the terms and conditions that would have been used in comparable independent transactions.

As per regulations published by gazette no. 2104/4 dated 31 December 2018 the arm's length price, referred to in sub Section (2) of section 76 and subsection (2) of section 77 of the Inland Revenue Act No. 24 of 2017 for the purpose of ascertaining income, gain or profits arising in, derived or accruing from or losses incurred in any transaction, operation or scheme entered into between two associated enterprises (hereinafter referred to as the connected transaction) should be calculated in accordance with the arm's length principle. The arm's length principle shall be understood as that where a transaction between associated enterprises is carried out considering the terms and conditions that would have been used in transactions with or between independent enterprises.

As per regulation 1 of the TP regulations transfer pricing regulations apply to domestic transactions made between associated enterprises referred to in Section 77 if –

a) there are tax exemptions granted to any one of the associated enterprises
b) any difference between income tax rates
c) any loss incurred by any of the associated enterprises

In terms of regulation 8 of the TP regulations for the purposes of Section 77(4) of the Inland Revenue Act and for these regulations, two enterprises shall be deemed to be associated enterprises, if, at any time during the year of assessment, any person or enterprise holds, directly or indirectly, shares or otherwise carrying the majority of the voting power in the other enterprise.

As per regulation 6 enterprises carrying out transactions with associated enterprises must maintain documents and submit information regarding controlled transactions, if those enterprises that carry out transactions or categories of transactions with associated enterprises whose aggregate value exceeds Rs. 200 million for each year of assessment as recorded in the books of account.

As per regulation 10 of the draft regulations where an adjustment is made by the Commissioner General of Inland Revenue under Section 77 to the taxable income of a taxpayer in relation to a domestic transaction, then, the Inland Department shall not make an appropriate adjustment to the taxable income of the other party to the transaction.

Accordingly, as the produce broking company is a fully owned subsidiary of UEL it is an associated enterprise. As both companies are resident companies and the domestic transactions between the two companies exceeds Rs. 200 million for each year of assessment, and different income tax rates are applicable to the two companies UEL needs to maintain TP documents.

(e) (i) In terms of section 178 of the Inland Revenue Act No . 24 of 2017,

The penalty on failure to file a tax return on time is the higher of;

(i) 5% of the amount of the tax owing, plus 1% of the amount of tax owing for each month or part thereof

or

(ii) Rs. 50,000/- plus Rs. 10,000/- for each month or part there of
However, the maximum penalty on this is Rs. 400,000.00

(ii) In terms of section 139 (1/2 a mark) of the Inland Revenue Act No 24 of 2017, UEL has to -

a) lodge an appeal (request for review) within 30 days from the date of the notice of assessment.
b) appeal should be in writing addressed to the CGIR and should state precisely the grounds of appeal.
c) the income tax return for the Y/A 2018/19 has to be filed with appeal,
d) the tax liability as per the return if any has to be paid and the payment receipt has to be attached .

The CGIR will –

a) acknowledge receipt of the appeal within 30 days from the date of receipt of the appeal,
b) on receipt of valid appeal, CGIR may cause further inquiry by an Assistant Commissioner other than the Assistant Commissioner who made the assessment.
c) where no agreement is not reached with Assistant Commissioner, CGIR shall fix a time to hear the appeal.
d) agree or determine every valid appeal received by CGIR within a period of ninety days from the date of receipt of said appeal.

As the matter on appeal is considered by the Commissioner General, most probably the decision will be against the Taxpayer. If so UEL should appeal against such decision under the new procedure laid down in the Tax Appeals Commission Act No. 23 of 2011.

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