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THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KC3 – Corporate Taxation

December 2015

SECTION 1

Answer 01

Relevant Learning Outcome/s:		
(a)	2.1.1	Interpret the meaning of resident status of an individual or company for tax purposes.
(b)	2.1.4	Assess the taxable income and the tax payable thereon by a non-resident person.
(c)	3.1.1	Outline the provisions of the Inland Revenue Act with regard to taxable sources, returns, assessments, time-bar, finality, appeals and penal provisions.
(d)	2.2.1	Explain the liability of a non-resident company for tax on remittances.
(e)	2.3.1	Explain the issue of overlapping tax jurisdictions and methods of avoiding double taxation.

Suggested detailed answer

(a)

This project is to last for three years, therefore there is a permanent establishment of CIEC as per the Sri Lanka China DTR Agreement. It will be treated as a non-resident company. This project has been registered as an overseas company with the Registrar of Companies.

When a company has its registered office or principal office in Sri Lanka, it can be deemed as a resident company of Sri Lanka. To have a registered office or principal office in Sri Lanka usually it has to be incorporated under the Companies Act in Sri Lanka. However, it seems that this project has not obtained such incorporation. Incorporation under the Companies Act and being registered as an overseas company are two different things. Therefore, it cannot be said that this project is a resident company in Sri Lanka.

A number of facts therefore have to be examined in this connection and the interpretation of case law must be relied on for precise facts.

A company incorporated outside Sri Lanka has a liaison office registered in Sri Lanka to carry out a project in Sri Lanka, and the day-to-day business decisions are made by a project manager in Sri Lanka. However, since the policy decisions are made at the head office outside Sri Lanka, its control and management are exercised outside Sri Lanka. Such a company will accordingly be treated as a non-resident company for tax purposes.

In this project, you can see that all of the important decisions are taken by the head office. Therefore, it cannot be concluded that this project has any control over the business in Sri Lanka. Therefore, this is not a resident company, but a non-resident company.

(4 marks)

(b) Total income tax liability of CIEC for the year of assessment 2014/15.

	Rs. million
01.01.2014 – 31.03.2014	604
01.04.2014 – 30.06.2014	327
01.07.2014 – 30.09.2014	106
01.10.2014 – 31.12.2014	324
01.01.2015 – 31.03.2015	73
	1,434

Foreign component = $1,434 \times 14\% = 200.76$

Local component = $1,434 \times 86\% = 1,233.24$

Profits and income from foreign component = $200.76 \times 6\% = 12.0456$

Profits and income from local component = $1,233.24 \times 12\% = 147.9888$

Income tax payable on foreign component = $12.0456 \times 12\% = 1.445472$

Income tax payable on local component = $147.9888 \times 12\% = 17.758656$

Total payable on profits and income = 19.204

Calculation of remittance tax

Total remittance = $75 + 100 = 175$

Remittance from dividends is not chargeable to tax = $175 - 15 = 160$

Remittance tax = $160 \times 10\% = 16$

Total income tax payable = $19.204 + 16 = 35.204$

(10 marks)

(c)

Internal Memo

Date: 28 December 2015

To: Board of Directors

From: Finance Director

Subject: Assessment for the year 2013/14

I am not agreeable with the assessment due to the under mentioned facts.

- Under Sections 45 and 46 of the Inland Revenue Act, profits and income received from any undertaking for construction of roads or bridges are chargeable to tax at a 12% rate. However, it is applicable to resident companies. In terms of the non-discrimination article of the double taxation avoidance agreement, a non-resident person should not have a tax burden different to that of a resident person on the same income.

It states as follows:

“Nationals of a Contracting State shall not be subjected in the other Contracting States to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected”

- Further, there is an interpretation given by the Department in this regard.
- Therefore, advice can be given to appeal against the assessment based on the above mentioned facts within 30 days from the date of notice of the assessment, by giving the grounds of appeal precisely in writing.

(5 marks)

(d)

- In terms of Section 106(4) of the Inland Revenue Act, any non-resident company is required to furnish a return on a half yearly basis on remittances, irrespective of the fact whether the remittance has been made or not. The section states as follows:

“Every company not deemed to be a resident in Sri Lanka, shall submit a return to the Commissioner-General on a half yearly basis on or before October 31 and April 30, of remittances made by such company as referred to in paragraph (b) of sub-section (1) of Section 62 containing such particulars as specified by him, including the details of remittances made during the period April to September and October to March respectively, in each year. Where there are no remittances made during such periods covered by such returns, a “NIL” return shall be submitted.”

- In terms of Section 112 of the Inland Revenue Act, a penalty is imposed for non-submission of a return. However, it appears that **no penalty** can be imposed when the return on remittance is not filed, because it is not specifically mentioned. Since this is a separate return, a penalty cannot be imposed on non-submission of a return of income.

(3 marks)

(e)

A DTR agreement says that when employment is exercised in any country, then the liability arises in that country.

However, it also says that if a particular employee exercises his employment for less than 183 days in the other country, and his remuneration is paid not by a resident person in that other country or it is not a burden to a permanent establishment of that other country, he is not chargeable to that other country (i.e. he is not chargeable to the country where he exercises his employment, but he is chargeable to the country where he is a resident).

In this particular situation, there is a permanent establishment (PE) in Sri Lanka that had paid these emoluments. It means that there is a tax burden to the PE of Sri Lanka. Therefore, irrespective of the fact that these employees have exercised employment in

Sri Lanka for less than 183 days, they are chargeable to tax, and therefore the PAYE table is to be applied and tax is to be deducted.

Further, it is not material whether the payments are made in rupees or in foreign currency or directly paid to employees or credited to their banks. Therefore, these employees are chargeable to tax in Sri Lanka.

(3 marks)

(Total: 25 marks)

Answer 02

Relevant Learning Outcome/s:		
(a)	4.1.1.	Assess the output tax, input tax and balance tax payable by a registered person in business which carries out multiple activities.
(b)	4.3.2	Outline significant features of the Simplified VAT Scheme.
(c)	6.4.1	Outline the penal provisions applicable to accountants, auditors and tax practitioners in respect of interpretation of provisions, frauds and incorrect returns.
(d)	6.2	Financial reporting and taxation

Suggested Detailed Answer:

(a)

Calculation of tax payable

Output tax

				Rs.
Manufactured and sold to local market	115,965,000	x 11%	=	12,756,150
Manufactured and sold to export market	186,420,000	x 0%	=	0
Purchased locally and sold to export market	123,454,000	x 0%	=	0
Manufactured and sold to exporters (RIPs)	25,830,000	x 11%	=	2,841,300
Total supplies	451,669,000			15,597,450

Input tax

Allowable input tax without any restriction

$$= \frac{\text{zero rated supplies} + \text{suspended supplies}}{\text{total supplies}} \times \text{allowable input tax}$$

In the case of any person who has been granted payment basis approval, he can claim input tax only if the payment has been settled in full on those invoices. Assuming that all payments have been made;

$$\frac{(186,420,000 + 123,454,000 + 25,830,000)}{451,669,000} \times 8,356,000$$

$$\frac{335,704,000}{451,669,000} \times 8,356,000 = 6,210,615$$

Balance claimable input tax is subjected to 100% restriction =

(allowable input tax + b/f input tax – input tax on zero and suspended supplies) is restricted to 100% of the output tax – suspended tax.

$$\begin{array}{lclcl} \text{Claimable input tax} & = & 8,356,000 + 4,346,000 - 6,210,615 & = & 6,491,385 \\ \text{Output tax – suspended tax} & = & 5,597,450 - 2,841,300 & = & 12,756,150 \end{array}$$

Since output tax is more than the claimable input tax, restriction is not applicable and therefore the entire input tax can be claimed.

Tax payable = output tax – input tax – SVAT credit

$$\begin{array}{l} = 15,597,450 - 6,210,615 - 6,491,385 \\ = 2,895,450 \end{array}$$

$$\begin{array}{l} \text{Therefore} \rightarrow 2,895,450 - 2,841,300 \text{ (SVAT credit)} \\ = 54,150 \text{ (payable)} \end{array}$$

(10 marks)

(b) SVAT 04 and SVAT 05 (2 marks)

(c)

(i) These are excluded supplies. (2 marks)

(ii) Among various matters mentioned in Section 66, the following is mentioned as an offence.

“makes any false return or false entry in any return made under this Act”

Among the various matters mentioned in Section 67, the following is mentioned as an offence.

“gives any incorrect information relating to any matter or thing affecting his own liability to tax or the liability of any other person”

Therefore it is an offence.

(2 marks)

(iii) The penal provision which is mentioned in Section 204A of the Inland Revenue Act relating to deliberate misinterpretation of the provisions of the Act or any other Act administered by the Commissioner-General by **any auditor or tax practitioner who in the discharge of his professional duty** says that it shall be guilty of an offence under the respective Act and on conviction after a summary trial before a Magistrate, be liable to a fine not exceeding rupees fifty thousand or to imprisonment of either description for a term not exceeding six months or to both such fine and imprisonment.

However, in this particular situation, the above provision is not applicable to the employee since he is not acting as an auditor or tax practitioner. He is not acting as an auditor or the practitioner though the company is liable under Sections 66 or 67 as explained above.

(2 marks)

(d) **Internal Memo**

Date: 28 December 2015

To: Board of Directors

From: Finance Director

Subject: Proposed Pricing Policy

Our price charged to customers comprises of various elements decided by the entity based on policies decided by us considering various factors. The finance cost is one of those items that can be identified clearly. Reporting the finance cost element separately as per the reporting standards and accounting policies laid down, will facilitate our stakeholders to understand the position and operational results. In our analysis it has to be considered whether this treatment is in accordance with the provisions of Sri Lankan tax law.

The interest element is also one of the matters considered for fixing the price and it is part of the revenue from sale of goods included in billing. Therefore it has to be considered as part of the revenue generated from sales of the company for tax purposes. It is not a separate source of income for tax purposes.

In order to clarify and provide a guide on those areas, the Minister of Finance and Planning has issued a guideline under Gazette Notification No. 1857/8 dated 9th April 2014 on adoption of Sri Lanka Financial Reporting Standards. As per item No. 7,

“In the case of deferred consideration, where imputed interest is embedded in sales revenue (broken down into sales and finance income portion), the entire value of the invoice shall be taken into account.”

As such there is no major impact on taxes of the company when compared to the proposal with the current position.

(7 marks)

(Total: 25 marks)

SECTION 2

Answer 03

Relevant Learning Outcome/s:		
(a)	1.1	Comprehensive income tax computations
(b)	5.1.1	Outline major tax holidays, exemptions and other incentives granted under the Inland Revenue Act and Board of Investment Law.
(c)	5.2.1	Explain statutory provisions relevant to transfer pricing (including the concept of "arm's length price" and prescribed (gazetted) methods of transfer pricing).
(d)	3.3.1	Demonstrate knowledge and application of statutory provisions, and case law in the following: <ul style="list-style-type: none"> - Practical tax issues including clarification of taxability of various profits and income - Deductibility of expenses (expenses and outgoings incurred in production of profits and income) - Interpretation of important concepts including "adventure or concern in the nature of trade", "expenditure in capital nature", "capital gain" and "income of casual and non-recurrence nature". - Rights and obligations of tax payers.
(e)	3.1	Statutory Provisions

(a)

Income tax computation of TSEL for the year of assessment 2014/15			
		Rs. '000	Rs. '000
Adjusted profit from business (Annexure 1)			22,585
Interest income:			
– fixed deposits			3,350
– quoted debentures			<i>Exempt</i>
Total statutory income			25,935
Income not part of the statutory income - dividend	1,150		
Deductions			
<i>Losses incurred</i>			
Total losses during tax holiday	(103,000)		
Profits during tax holiday	<u>15,000</u>		
Total losses incurred during tax holiday	(88,000)		
35% of total statutory income	<u>9,077</u>		
Losses carried forward	(78,923)		9,077

Assessable income			16,857
Less: Qualifying payments			
Investment in community development project (maximum Rs. 10 million)			1,267
Donation subject to $\frac{1}{5}$ of AI or 500,000, whichever is less		620	500
Taxable income			15,090
Computation of tax liability			
Interest income			
(Taxable income x interest income)/total statutory income			
(15,090 x 3,350)/25,935	@ 28%	1,949	545
Balance income			
(Taxable income x trade income)/total statutory income			
(15,090 x 22,585)/25,935	@ 12%	13,141	<u>1,577</u>
Total gross tax liability			<u>2,122</u>

Annexure 1

Profit from business				
			+	-
			Rs.	Rs.
Profit/(loss) before tax				3,774
Disallowable items				
Depreciation			27,799	
Entertainment			6,710	
Advertising				
- Advertising cost incurred outside Sri Lanka	Allowed	4,760		
- Advertising outside Sri Lanka (for setting up an office)			4,370	
- Advertising in Sri Lanka (25%)		3,730	933	
Bad debts			140	
Provision for bad debts			8,780	
Provision for gratuity			2,260	
Lease interest			1,650	
Exchange loss			4,000	
Revaluation expenses			680	
Rent (related to next year)			7,500	
Foreign travel expenses (Note 1)		4,700	1,240	
Fall in value of shares			2,360	
Transfer to RRF			17,000	
Donation			620	
Cost of drinking water project			1,267	

Planting trees			3,000	
Damage to visitor			2,600	
Items considered separately				
Interest income	Debenture			1,900
Interest income	FD			3,350
Dividend income				1,150
Items allowed				
Gratuity payment				400
Depreciation allowance – Plant – 100%				52,000
Replacement of crockery and cutlery				1,750
Lease rentals				6,000
			92,909	70,324.00
Adjusted profit from business				22,585

Note 1 – Foreign travel expenses				
		Disallowed	Allowed	
Setting up office	1,240	1,240		
Promotion of tourism	3,400		3,400	
Other	60		60	Less than 2% of adjusted profit from trade of previous year
	4,700	1,240	3,460	
Note 2 – Lease rentals				
Lease rentals payable for motor cars			68,000	
¹ / ₅ of the total lease rentals payable			13,600	
Actual lease rental payments			6,000	
Allowed			6,000	
Note 3 – Depreciation allowance				
Cost of construction of wind power plant			52,000	
Depreciation allowance			100%	
Allowance for the year			52,000	

(25 marks)

- (b) The company had commenced the hotel project in 2006. According to Section 17(2)(b) of the Inland Revenue Act and the regulations published in Gazette No. 1487 dated 5th March 2007, the hotel project of the company qualifies for income tax exemption as its investment is in excess of Rs. 250 million. Therefore, the undertaking of the company is exempt from income tax for a period of 5 years. Such exemption commences in the year of assessment in which the undertaking commenced to make profits, or after completes two years reckoned from the date on which it commences to carry on commercial operations, which occurs earlier. Accordingly, the income tax exemption period has commenced from the Y/A 2011/12, as the company has made losses for the years of assessment 2008/09, 2009/10 and 2010/11. However, the above tax exemption period will be reduced to 3 years, if the exemption of income tax has commenced after 31 March 2008. As a result, the income tax exemption period of the company has ended in Y/A 2013/14 and therefore no further income tax exemptions are available to the company under this scenario.

However if the company providing services to a non-resident person in or outside Sri Lanka and thereby earns foreign currency and remitting such foreign currency through the bank are exempt under Section 13(ddd).

(7 marks)

- (c) **To:** Board of Directors
From: Tax Consultant
Subject: Transfer Pricing

Any profit and income (or loss) arising in transactions entered into between two associate undertakings shall be ascertained with regard to the arm's length price. An undertaking shall be deemed to be an associated undertaking of another undertaking, if the first-mentioned undertaking participates directly or indirectly or through one or more intermediaries, in the control of the second-mentioned undertaking in such a manner or to such extent as may be prescribed.

Based on the given information, the following activities or areas of TSEL may have an exposure to transfer pricing:

- Using the ITA network to promote TSEL and commission payable to ITA
- Using transport services of MA Holding PLC
- Possible architectural work by JMADCL in the proposed development on the adjoining land
- Any other activities carried out with related parties shown in the financial statements

(7 marks)

- (d) Any disbursement or expenses not incurred for the purpose of production of income cannot be deducted as per Section 26(1)(g) of the Inland Revenue Act No. 10 of 2006. As such, the money paid to a resident guest as damages has to be reviewed in order to ascertain the deductibility. It is prudent to see whether this kind of payment is necessary or common to this nature of business.

In the case of *Strong v Woodfield* this matter was emphasized. The company sought to deduct from its trading profits a sum expended to pay damages for personal injuries to a visitor to the taxpayer's Inn. The claim was rejected. *Lord Davey said: 'I think that the payment of these damages was not money expended 'for the purposes of the trade'. It is not enough that the disbursement is made in the course of, or arises out of, or is connected with, the trade, or is made out of the profits of the trade.'*

In this case Rs. 2.6 million has being paid by TSEL to a guest for the injuries caused to his head as a result of the collapse of a ceiling mounted chandelier. This incident is not common to each and every tourist hotel or lodge or of a recurrent nature, although the legal liability is there.

Therefore the payment of damages cannot be considered as expenditure incurred for the purpose of trade.

(7 marks)

- (e) According to Section 106(4) of the Inland Revenue Act, every company deemed to be resident in Sri Lanka, shall submit a return to the CGIR for each year, on a half yearly basis, on or before October 31 and April 30, of dividends declared, containing the particulars of the dividends declared during the period of April to September and October to March.

As per the Section, even where no dividend is paid or declared during the above periods, a NIL return shall be submitted.

(4 marks)

(Total: 50 marks)

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