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

# SUGGESTED SOLUTIONS

**KE3 – Fundamentals of Taxation & Law**

**September 2015**

**Part A**  
**Taxation**  
**SECTION 1**

**Answer 01**

1.1.

Learning Outcome: 2.1.3

Explain the meaning of "person", year "year of assessment", sources of profits & income" and the "residence rule".

Correct answer: C

1.2.

Learning Outcome: 3.1.2.

Explain specific adjustments applicable to the computation of statutory income of a company, from rent, interest, dividend and profit from trade or business (other than adjustments applicable to intercompany transaction)

Correct answer: A

1.3.

Learning Outcome: 4.3.1.

State the interpretations for tax purposes of the following terms , person, child, trade, business, executive officer and precedent partner

Correct answer: C

1.4.

Learning Outcome: 5.1.2.

Explain the applicability of VAT to small and medium-sized businesses along with the registration "threshold".

Correct answer: C

1.5.

Learning Outcome: 5.2.4.

Explain the due dates of payment and submission of returns.

Correct answer: D

**[Total: 10 marks]**

## Answer 02.

2.1

Learning Outcome: 1.2.1 State the role of the following tax authorities in Sri Lanka
Correct answer: Income tax, Value Added Tax, Nation Building Tax, Economic Service Charge, Stamp Duty.

2.2

Learning Outcome: 3.1.3 Compute total statutory income, assessable income and taxable income of a company, by making relevant statutory deductions.	
Correct answer:	Rs.
Adjusted Profit from trade	950,000
Dividend Received	-
will not form part of statutory income	
<b>Total Statutory income</b>	<b>950,000</b>
Less: Losses b/f	<u>(150,000)</u>
<b>Assessable Income</b>	<b>800,000</b>
Less: Donation to Approved Charity	<u>(50,000)</u>
<b>Taxable Income</b>	<b><u>750,000</u></b>

2.3

Learning Outcome: 3.1.5. Explain the tax liability of a company on distributions.
Correct answer: (i) At least 10% of the distributable profit should be distributed as dividends. (ii) Gross dividends should be made on or before 30 September 2015. That is 18 months from the commencement of the year of assessment.

2.4

Learning Outcome: 4.2.1. State circumstances for issue of assessments and the statutory provisions for rejection of return by the assessor.
Correct answer: Within 18 months from the statutory date of filing the return. That is on or before 31 May 2016.

2.5

Learning Outcome: 4.5.3 Explain the concept of final tax.
Correct answer: Since PAYE on Employment Income and Withholding Tax on Interest Income have been duly deducted, <b>he is not required to submit his return of income.</b> It means his income has been treated as final.

**(Total: 10 marks)**

## SECTION 2

### Answer 03

Learning Outcome:

- 2.2. Statutory income from sources of profits & income listed in the Inland Revenue Act
- 2.3. Total statutory income, assessable income and taxable income
- 2.4. Gross income tax and balance tax payable

Dr. Ruwan

### Computation of Income tax payable for the Y/A 2014/15

	Rs.		
<b>Employment income from the main employer</b>			
Salary - 135,000 x 12			1,620,000
Reimbursement of private travelling (per month it is less than 50,000 ,therefore it is exempt)			
Reimbursement of telephone bills 38,000 x 50%			19,000
Reimbursement of medical expenses			200,000
Employer's contribution to the provident fund (Not liable since the fund is approved by the CGIR)			-
			1,839,000
Employment income from the second employer - '924,000/84 x100			1,100,000
<b>Statutory income from employment</b>			<b>2,939,000</b>
Business Income	+	-	
Net profit as per Income Statement	1,777,000		
Profit on sale of the blood pressure meter (note 1)		2,000	
Foreign travelling -Accommodation-123,000-allowed			
Previous year adjusted profit=1,872,000 (2% of 1,872,000=37,440)=54,000-37,440	16,560		
Salaries paid to wife - allowed			
Purchase of medical equipment	75,000		
Depreciation allowance on the new pressure meter =21,000 @33 1/3%		7,000	
Depreciation allowance on new medical equipment =54,000 @33 1/3%		18,000	
	1,868,560	27,000	
<b>Adjusted Profit</b>			<b>1,841,560</b>

Salaries paid to wife			<b>175,000</b>
<b>Total Statutory Income</b>			<b>4,955,560</b>
<b>Less: deductions under section 32</b>			
Interest paid on a loan taken for a wedding - Not allowed			
<b>Assessable income</b>			<b>4,955,560</b>
<b>Less qualifying payments</b>			
- Qualifying payment on employment income		100,000	
- EPF contribution - not a qualifying payment			
- Life policy premium Rs.80,000 (Limited to lower of Rs. <b>75,000</b> and <b>1/3 of AI</b> )		75,000	
- Insurance - incurable decease - <b>100% allowed</b>		75,000	
- Capital repayment of the loan is not a qualifying payment (Note 2)			(250,000)
Personal allowance			(500,000)
<b>Taxable income</b>			<b>4,205,560</b>

<i>Calculation of Gross Income Tax</i>			
1st	500,000	4%	20,000
2nd	500,000	8%	40,000
3rd	500,000	12%	60,000
Business income-As a professional(59f)	1,841,560	12%	220,987
	864,000	16%	138,240
	<b>4,205,560</b>		
<b>Gross income tax payable</b>			<b>479,227</b>
<b>Less: tax credits</b>			
Self-assessment		20,000	
PAYE - main employer		91,000	
PAYE - second employer		176,000	(287,000)
<b>Balance payable</b>	-		<b>192,227</b>

Note 1:

Since no capital allowance was claimed on old machine the adjusted profit/(loss) on the disposal of blood pressure meter is not taxable.

Note 2:

Nothing can be deducted as qualifying payments if the income is solely from employment income.

However, he has enough other sources of income, and therefore, life policy premium and medical insurance policy premium can be deducted up to the extent of other income.

**(Total: 20 marks)**

NOT FOR SALE

**Part B**  
**Legal Fundamentals**  
**SECTION 1**

**Answer 04**

4.1.

Learning Outcome: 1.1.1. Identify the main branches of the Sri Lankan Legal system and their roles.

Correct answer: B

All the other conditions given in the answer should be present, for a custom to be recognized by the courts as a source of law. Whereas there is no need for parliament to pass subordinate legislation for a custom to be recognized by courts as a source of law.

4.2.

Learning Outcome: 3.1.1. Discuss the difference between a contract for sale of goods and a contract for work and materials, and the classification of said goods.

Correct answer: B

4.3.

Learning Outcome: 5.6.1. Explain the liability of the state for acts done by its agents.

Correct answer: B

All the others are instances where the State is not liable for the acts of its agent.

4.4.

Learning Outcome: 6.2.2. List obligations of the hirer and owner.

Correct answer: C

All the others are obligations of a hirer under a hire-purchase agreement.

4.5.

Learning Outcome: 8.1.1. Define fraud, theft, money laundering, bribery, negligence and explain the main defences.

Correct answer: C

All the others are defences for theft.

**(Total: 10 marks)**

## Answer 05

5.1.

Learning Outcome: 2.1.1. Explain the requisites of a valid contract i.e. offer and acceptance, intention to create legal relations, considering (including the concept of "LaesioEnormis"), "capacity and form". Definition of contract, agreement, offer and acceptance, capacity to contract, form of contracts, "reality of consent".

The following rules should be complied with, in order for an acceptance to be treated as a valid acceptance in the law of contracts.

- The acceptance must be made when the offer is still in force.
- The acceptance must be absolute/unconditional.
- The acceptance must be unqualified.
- The acceptance must be communicated to the offeror.

5.2.

Learning Outcome: 3.2.1. Explain the implied conditions and warranties, which are applicable in a contract for sale of goods.

As per the Sale of Goods Ordinance No.11 of 1896, the following implied terms apply in relation to the title of this TV.

- (i) There is an implied condition that the seller, has the right to sell the goods at the time the property in goods passes to the buyer.
- (ii) There is an implied warranty, that the buyer will have and enjoy quiet possession of the goods.
- (iii) There is a further implied warranty, that the goods will be free from any encumbrance or charge, which was not known to the buyer at the time of sale.

[Section 13 of the Sale of Goods Ordinance ]



5.3.

Learning Outcome: 1.4.1.

Explain the regulatory role of each of these institutions.

Institute of Chartered Accountants, Sri Lanka Accounting Standards Monitoring Board, Securities and Exchange Commission, Colombo Stock Exchange, Board of Investment, Registrar of Companies, Dept. of Customs, Central Bank (Exchange Control aspect).

The main functions of the BOI are as follows :

- To attract foreign direct investments and domestic investments.
- To assist investors at all stages of the process, from the application stage to commercial operation.
- To establish and manage export-processing zones, which are available to investors to set up industrial and commercial enterprises.
- To diversify the sources of foreign exchange earnings and to increase the export earnings.

5.4.

Learning Outcome: 9.1.2. Explain the process of international commercial dispute resolution.

In general, the process of mediation is as follows.

- The disputing parties appoint a neutral third party to act as a mediator.
- The process of mediation is determined by the mediator and the parties collectively. Generally, each disputing party lists out the key issues of the dispute and submits these to the mediator and to each other.
- Thereafter the mediator makes his decision. This decision is not binding on the parties. It is up to the parties to accept it or not.

The Mediation Boards Act No. 72 of 1988 too lays down the procedure to be followed in a mediation [Section 10]. This process is as follows :

- (a) All disputes where the value of the claim is less than Rs. 250,000 must be first referred to the Mediation Board for mediation.
- (b) The Mediation Board will notify the disputants to attend a mediation conference.
- (c) It can also require to bring witnesses and documents, if necessary, to such conference. The Board will convene as many such mediation conferences as necessary, to arrive at a settlement.
- (d) These proceedings should be completed within the time period specified under the Act (section 13).
- (e) Where a settlement is reached, the terms of the settlement shall be recorded in writing and signed by the Chief Mediator, and given to either the disputants or courts, as applicable.
- (f) Where a settlement is not reached, the Board will issue a certificate of non-settlement signed by the Chief Mediator.

Learning Outcome: 8.2.1. Comment briefly on each of these Acts: Prevention of Money Laundering Act. No. 05 of 2006. Electronic Transaction Act No. 19 of 2006. Computer Crimes Act. Consumer Protection Act, Intellectual Property, Act No. 36 of 2003.

- The main purpose of registering an Industrial Design is that the owner gets exclusive ownership over such Industrial Design.
- All registered designs will be recorded in the “**Register of Industrial Designs**”, which is a public document that can be inspected by any person.
- The registration is valid for an initial period of 5 years from the date of receipt of the application for registration.
- This term can be renewed for two more consecutive 5-year terms, at the option of the author.

[Total: 20 marks]

## Section 2

### Answer 06

Learning Outcome:

2.2.1 Explain what is meant by the terms of contract and the effect of exemption clauses and the Unfair Contract Terms Act No.26 of 1997.

2.5.1. Explain the Common Law and Equitable remedies for breach of contract.

2.5.2. Explain the principle of unjust enrichment.

In the given scenario there are a few violations of the Law of Contracts by Frooty. Given below are 3 such violations and the remedies available to the Hotel for each such violation.

- (a) The first such violation is that he failed to supply the required quantity of fruits for August 2015 as per the contract.

Total fruits requirement of the hotel should be supplied by Frooty. Since this is a main term of the contract, which goes to the very root of the contract, it is considered as a condition of the contract. Therefore, failure by Frooty, to meet the required demand in August, amounts to a breach of a condition of the contract by him.

A breach of a condition entitles the affected party to rescind the contract and claim damages. Accordingly, the Hotel has a right to rescind the entire contract and claim damages from Frooty for the violation of this condition of the contract.

- (b) The second violation is the failure of Frooty to supply fruits of a good quality in the month of August.

The supplying of good quality fruits is an implied obligation or a term of the contract. But it can be treated as a warranty of the contract because the failure to perform it does not affect the substance of the contract.

For this violation Cookie's Hotel is not entitled to rescind the contract, but it can only claim damages from Frooty.

- (c) The third violation is that Frooty had made a false statement to the Hotel, at the time of entering into the contract in order to induce it to enter in to the contract, in relation to his ability and capacity to supply the required quantity of fruits for the given period.

Since this false statement was made by Frooty knowing very well that it is not true, it amounts to a fraudulent misrepresentation under the Law of Contracts.

In such a situation, the hotel as the innocent party, can exercise any of the following remedies.

- Rescind the contract, or
- Claim damages, or
- Refuse to perform the contract, or
- Refuse to affirm the contract.

**(Total: 10 marks)**

## Answer 07

Learning Outcome:

5.7.5 State the relationship between partners.

5.7.6 State the relationship between partners and third parties.

### Part (a)

Bunty, as a partner in the partnership business, has to adhere to certain duties towards his fellow partners and the partnership.

But in the given scenario, Bunty has breached some of these duties as follows :

- Every partner should render true accounts and full information on all his dealings affecting the partnership.

This duty was breached, when Bunty did not account for the benefits he derived in engaging in the purchases of the partnership.

- Every partner should account to the firm for any benefits derived by him without the consent of the other partners from any transactions concerning the partnership.

This duty has been breached by Bunty when he gave the complimentary gifts to his children, without informing the partnership or the partners.

- Every partner must disclose any secret profit he makes in dealing with the firm and account for that profit to the firm.

This duty was breached when Bunty fabricated the purchase bills to include part of the complimentary gift items, thereby making a secret profit.

**Part (b)**

In Partnership Law, every partner is considered as an agent of the firm and of his fellow partners for the purposes of the firm.

Therefore, the acts of every partner in carrying on the business of the firm in the usual way will be binding on the firm and on the other partners.

In the given scenario, Chandy collected the advance of Rs. 700,000 from Dandy, on behalf of the firm and as an agent of the firm and in the carrying on of the business of the firm in the usual way.

Further, it is also implied from the fact that Chandy was in charge of the sales of the partnership, that he had implied authority to bind the firm in the receipt of payments from the customers of the firm.

Therefore, from the given facts, it could be said that the firm and the partners are collectively and jointly liable for the advance collected by Chandy on behalf of the firm, and therefore it is the firm that will be held liable on this loss.

Based on the above reasoning, Chandy will not be held liable personally, but as a partner of the firm, he will be held jointly liable with the other partners.

**(4 marks)**

**(Total: 10 marks)**

## Answer 08

Learning Outcome: 3.4.1. Explain the remedies, which are available to a buyer and seller, including rights of an "unpaid seller".

### Part (a)

From the given facts, it seems that the packet of milk powder purchased by Brenda was not fit for its purpose and was not of a merchantable quality.

This results in the breach of an implied warranty in a sale of goods contract by Anton.

Therefore, Brenda is in a strong legal position to recover damages from Anton.

But as Anton had, before purchasing the 150 packets of milk powder, inspected and tested a sample to satisfactory results, it could be deduced that this defect was one that could not be discovered by a reasonable examination of the sample.

Therefore Anton can in turn recover damages from Titus as follows:

- (i) To recover the costs incurred by Anton, as a result of Brenda's claim on him. For the breach of an implied term of a sale of goods, in relation to a sale by sample.

Learning Outcome: 6.1.3. Explain the applicable principles in a contract of insurance relating to *uberrimae fidei*, curable interest and indemnity (including total and partial insurance).

### Part (b)

A fundamental principle in the law of insurance is the principle of "*uberrimae fidei*" or "utmost good faith".

This principle imposes a duty on the insured, in this case Wilfred, to disclose to the insurer in the proposal form, every material fact that he knows, which may enable the insurer to evaluate the risk that the insurer is going to undertake.

Therefore, the non-disclosure of the past conviction by Wilfred constituted a moral hazard as well as a non-disclosure of a material fact, which the insurer would have had to assess before accepting the risk.

Similar facts were expressed in the decided case of **Woolcott vs Sun Alliance and London Alliance Ltd.** (1978) 1 W.L.R. 493.

Therefore, from the given facts, it seems that Wilfred has breached the principle of *uberrimae fidei*.

Therefore, the insurer is entitled to avoid this policy and reject the payment on this policy.

**(Total: 10 marks)**

## Answer 09

Learning Outcome: 4.2.1. Explain, in respect of the following, the applicable principles of cheque law and their commercial significance (endorsements, crossings, dishonour and banker's liability).

### Part (a)

The cheque that Sunil has with him, falls within the category of an “order bill” or an “order cheque”, for the reason that the drawer has given an order to pay Sunil and not any other bearer of the cheque, as well as a direction to the paying bank that the cheque should be paid only through a bank account.

But even though it is an order cheque, it can still be negotiated by Sunil as its holder in due course, by making an endorsement on it.

For this endorsement to be valid the following requisites must be satisfied by Sunil. They are :

- The endorsement must be written on the bill/cheque itself, and signed by Sunil as the endorser, and
- The entire cheque amount must be endorsed. (i.e.: It must be an endorsement of the entire cheque amount).

*[Sec. 32 of the Bills of Exchange Ordinance ]*

Once the cheque has been endorsed validly, then Hardy can accept this cheque, and encash it by banking it to his bank account.

Learning Outcome: 7.4.1. Explain the procedure for termination of employees under the Termination of Employment Workmen (Special Provisions) Act.

### Part (b)

As per Termination of Employment of Workmen (Special Provisions) Act No. 45 of 1971, the termination of employees in Scheduled Employment, can be done by an employer, only upon the fulfillment of certain conditions.

These conditions are as follows :

- The prior written consent of the employee to be terminated, must be obtained; or
- The prior written approval of the Commissioner of Labour must be obtained

But as per the given scenario it seems that the employer has not followed either of the above conditions.

Therefore, this amounts to a violation of the Act, and hence Edgar’s termination is illegal, and null and void.

**Alternatively**

As per Termination of Employment of Workmen (Special Provisions) Act No. 45 of 1971, the termination of employees in Scheduled Employment, can be done by an employer, only upon the fulfillment of certain conditions.

These conditions are as follows :

- The prior written consent of the employee to be terminated, must be obtained; or
- The prior written approval of the Commissioner of Labour must be obtained.

But on the other hand, if the employer had followed either of the above conditions, then it could be said that Edgar's termination is in order and hence valid.

**(Total: 10 marks)**



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