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THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KB3 – Business Taxation and Law

June 2019

SECTION 1

Answer 01

(a)

Relevant learning outcome/s: 1.3.1 and 1.3.2

1.3.1 Explain the concept of “organisational personality” and its legal consequences.

1.3.2 Demonstrate instances where the concept of organisational personality is applied, with relevant cases.
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Study text reference: Pages 7 and 11

(Note: The answer given below is only a guideline. Marks should be given if a candidate has captured the essence of this answer).

Per the legal concept of “separate legal personality”, a limited liability company is considered a separate legal person to its owners.

E.g. Salomon v Salomon Co. Ltd
Macaure v Northern Assurance

Therefore in the given scenario GPL is a separate legal person in the eyes of the law, whilst G is another legal person. In other words they are two different legal persons in the eyes of the law.

Per the understanding between the parties stated in the given scenario, the land belongs to G and the trees belong to GPL. Since the trees are GPL's it is implied that the fruit of the trees (the coconuts) too will belong to GPL.

Therefore as the coconuts (which were spoilt) belonged GPL, R should file action for damages against the owner of the coconuts, namely GPL.

(b)

Relevant learning outcome/s: 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.

Study text reference: Page 74

Companies Act: Section 206

Candidates were expected to briefly and clearly state the procedure to remove a director.

As the company's Articles of Association are similar to the Model Articles given in the First Schedule of the Companies Act, the following steps should be taken by the shareholders to remove the director from the board.

- Give notice of an extraordinary general meeting (EGM) of the shareholders. The notice should say that one purpose of calling this EGM is for the removal of the particular director from the board.

- When this notice is given, the concerned director has a right to make a representation within 14 days of the date of the notice.
- The company is required to circulate this representation to its shareholders or read it at the EGM, unless the company obtains court permission not to do so.
- Thereafter at the EGM if the shareholders pass an ordinary resolution for the removal of this director, he shall stand removed from the board.

(Total: 10 marks)

Answer 02

(a)

Relevant learning outcome/s: 2.2.1, 2.2.3 and 2.2.4

2.2.1 Explain the process involved for registration of a company.

2.2.3 State the types of forms to be submitted to the ROC and their contents.

2.2.4 Explain the documentation involved for registration of a company (public and private).

Study text reference: Pages 26, 27 and 28

Companies Act reference: Sections 4, 5, 6 and 9

Candidates were expected to briefly list the steps and documents required to incorporate a private limited company. They were not expected to explain them in detail. The explanations given below are for the purpose of clarity.

Given below are the steps to be followed and the documents to be filed with the Registrar of Companies (ROC) in order to incorporate a private limited company.

Step 1: Name approval

The first step is to obtain the approval from the ROC for the proposed name.

Step 2: Incorporation documents

Once the name approval is received from the ROC, the following documents should be prepared and filed with the ROC.

1. **Application form to incorporate the company (Form 1)**
This must be signed by all the initial directors, initial shareholders and the company secretary.
2. **Articles of Association (AOA)**
It is possible to adopt the Model Articles in the First Schedule to the Companies Act. However, if a separate AOA is prepared, it need not necessarily have the objects clause. The AOA should be signed by all the initial shareholders, directors and company secretary.
3. **Consent form of the directors (Form 18)**
For each director a separate Form 18 should be prepared and signed by him/her. It will include the details of the director such as his/her full name, residential address, occupation, NIC/passport number and nationality.

4. **Consent form of the initial secretary (Form 19)**

This will include the details of the secretary and his/her signature to indicate the consent to act as the secretary.

Step 3: Certificate of Incorporation

Once the above mentioned documents are filed and are accepted as complete by the ROC, the Registrar will enter the details of the company in the register and assign a unique number to the company. Thereafter the Certificate of Incorporation will be given to the company.

Step 4: Public notice of incorporation

Within 30 working days from the date of incorporation under Section 9 of the Act, notice must be given in the gazette and newspapers in all three languages. The notice must state the name of the company, registration number, registered address and the principal place of business if it differs from the registered address of the company.

(b)

Relevant learning outcome/s: 2.4

Articles of Association (AA)

Companies Act reference: Section 18

(Note: The answer given below is only a guideline. Marks should be given if a candidate has captured the essence of this answer).

Candidates were expected to give their conclusion and also the reasons for their conclusion.

As a shareholder Amara has a right at any time to request the company in writing for a copy of its Articles of Association (AOA).

However, the company can decline to provide a copy of the AOA to Amara, if a copy was provided to her within the previous 6 months.

Since she has not asked for a copy during the last 6 months (she last asked in 2015), the company cannot decline to give her a copy now.

(Section 122 of the Companies Act also talks about obtaining a copy – but Section 18 is more relevant in this case)

(Total: 10 marks)

Answer 03

(a)

Relevant learning outcome/s: 3.1.2

Compare and contrast the procedures for the issue of shares (including “issues at a premium or at a discount”).

Study text reference: Pages 48 and 49

(i)

Companies issue shares as a means of raising additional capital. Before issuing shares a company will issue applications to persons and invite them to subscribe for the shares.

The law requires such persons to be given all material information relating to the company, in order for them to make informed investment decisions.

Therefore, a document containing all such information is given to the prospective subscribers. Such a document is called a prospectus.

Alternative answer

A prospectus is a document issued to persons (to whom invitations and applications to subscribe for the shares of the company are given), stating all material information relating to the company, in order for them to make informed investment decisions.

(ii)

The Companies Act (Section 37(3)) says that a prospectus is not required in the following situations.

- Where an application is issued with the bona fide invitation to underwrite an issue.
- Where the offer is not made to the public.
- Where the offer is made in relation to a commercial paper by a company listed on the stock exchange.
- Where the offer is issued to existing shareholders.

(b)

Relevant learning outcome/s: 3.2.1 and 3.2.2

3.2.1 Explain the procedure for payment of dividends including that of a listed company.
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3.2.2 Explain the importance of the “Solvency Test” and capital maintenance mechanisms.

Study text reference: Pages 52 and 53

Companies Act reference: Sections 56, 57 and 60

(Note: The answer given below is only a guideline. Marks should be given if a candidate has captured the essence of this answer).

- (i) To pass the solvency test in terms of Section 57 of the Companies Act, it should be established that the company is able to pay its debts as they become due in the normal course of business; **and** that the value of the company’s assets is greater than the aggregate value of its liabilities and stated capital.

(ii) In the given scenario:

- The first condition of being “able to pay its debts as they become due in the normal course of business” has been fulfilled by the company per the confirmation received by the directors and the auditor.
- To determine whether the company can pass the second condition, the following calculation is considered.
 - Total assets = Rs. 200 million
 - Total liabilities + Stated capital = Rs. 170 million
 - Therefore total assets are greater than the aggregate of the total liabilities and stated capital.
 - Therefore the second condition is also fulfilled by the company.
- Therefore as both conditions can be satisfied by the company, it can pass the solvency test immediately after it makes the proposed dividend distribution.

In the given scenario, as the company can pass the solvency test after making the proposed dividend, the company can go ahead and declare this dividend.

In other words, for a company to declare a dividend it should pass the solvency test (As dividends is treated as a distribution under Section 56 of the Companies Act, in order to make a distribution a company must pass the solvency test).

(Total: 10 marks)

Answer 04

(a)

Relevant learning outcome/s: 5.1.1 and 5.1.2

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

5.1.2 Prepare a notice for an Annual General Meeting.

Study text reference: Pages 94 and 95

Notice of the Annual General Meeting

NOTICE IS HEREBY GIVEN that the Annual General Meeting of Sarupath (Pvt) Ltd will be held on 10 September 2019 at 10.30 a.m. at Gimanhala Hotel, Colombo 3.

AGENDA

1. Notice of meeting.
2. Propose to declare a dividend of Rs. 5 million to the existing shareholders of the company.

By order of the board

Company secretary

Colombo

..... June 2019

Notes

A member entitled to attend and vote at this meeting is entitled to appoint a proxy to attend and vote instead of him/her. A proxy need not be a member of the company. A Form of Proxy accompanies this notice. Any proxy should be sent to the registered address of the company at Colombo, hours prior to the meeting.

(b)

Relevant learning outcome/s: 6.1.1

6.1.1 Differentiate “compulsory and voluntary winding up” and explain their consequences.

Study text reference: Pages 17, 18 and 118

Companies Act reference: Section 324

(i)

A declaration of solvency is a declaration made by the directors of a company by a majority decision at a meeting of the board of directors, stating that they have made a full inquiry into the affairs of the company, and that they are of the opinion that the company will be able to pay its debts in full within twelve months from the commencement date of the winding up.

Section 324(1)

Once this declaration is made it must be delivered to the Registrar for it to have any effect.

(ii)

Section 324(2)

When considering the accuracy of statements (A) and (B) in the scenario, the following should be considered:

The Companies Act says a winding up where a declaration of solvency has been made and delivered to the Registrar is called a “shareholders’ voluntary winding up”. And when such a declaration has not been made and delivered to the Registrar, it is called a “creditors’ voluntary winding up”.

Section 324(3)

Therefore, it can be said that Statement (A) in the given scenario is accurate.

Further it can be seen that Statement (B) in the scenario is not accurate, as a declaration of solvency is required for a shareholders’ voluntary winding up and not for a creditors’ voluntary winding up.

(Total: 10 marks)

Answer 05

(a)

Relevant learning outcome/s: 7.1.4
Explain “insider dealing” and relevant information.
Study text reference: Pages 145, 146 and 147
Companies Act reference: Sections 32 and 34

(Note: The answer given below is only a guideline. Marks should be given if a candidate has captured the essence of this answer).

Candidates were expected to give a brief explanation to justify their conclusion. They were not expected to mention the section numbers.

The Securities and Exchange Commission Act says that an individual who is, or at any time during the preceding six (6) months has been, knowingly connected with a company, shall not trade in listed securities of that company if he/she has information that he/she holds by virtue of being connected with the company.

Section 32

Further the Act says that a director of a company is a person who is “connected with” the company.

Section 34

In the given scenario as Mahen (M) is presently a director of ABC PLC, he is treated as a person connected with the company.

Therefore M is an “insider” in relation to this proposed transaction.

Therefore if M purchases any listed shares of ABC PLC immediately, he will be violating the regulations of insider trading according to the provisions of the Act. That means M cannot purchase these 10,000 shares without violating the Act/regulations.

(b)

Relevant learning outcome/s: 8

Alternate dispute resolution.

Study text reference: Pages 154 and 155

Candidates were expected to write the main points only.

The advantages of resolving this dispute by Alternative/Alternate Dispute Resolution (ADR) methods are:

- Expedient adjudication of disputes (i.e. disputes can be settled fast).
- Adjudication at a lower cost.
- Involvement of sector-specific personnel to adjudicate on disputes, which will lead to more informed and reasonable resolution of disputes.
- Resolution of disputes without the involvement of judges and lawyers.
- Less focus on legal technicalities and more focus on the actual dispute.
- More involvement by the parties to the dispute encourages a more amicable resolution of the dispute.
- Greater level of confidentiality (depending on the process adopted by the parties).
- The adjudication body focuses on only one dispute at a time and not on multiple disputes, as is done in a court of law. This allows for a more focused decision.
- More flexible procedure, which allows the parties to circumvent unnecessary documentation, evidence, etc. and also allows more stringent time limits to be imposed on the presentation of arguments.

(Total: 10 marks)

SECTION 2

Answer 06

Relevant learning outcome/s: 1.2 and 1.3

1.2 Taxable income of a company.

1.3 Gross income tax and balance tax payable.

Study text reference: Chapter 2

(a)

Stella Beach Hotel (Pvt) Ltd Income tax computation for the year of assessment 2018/19

			Rs. '000
Business income (Note 1)			3,580
Investment income:			
- Interest income from treasury bills		1,900	
- Dividend income (WHT deducted)			-
Rent income:			
Ticketing agency (760,000 * 12)	9,120		
Less: Painting expenses	(350)	8,770	10,670
Total assessable income			14,250
Less: Qualifying payments			
- Donation made to the government (full cost can be claimed)			(1,434)
Taxable income			12,816
Tax liability at 14% (Tourism > 80% of total income) (Note 2)			1,794
Tax credits:			
- ESC paid			(600)
- WHT (Note 3)			(1,200)
- SA payments			(200)
Income tax payable/(refund due)			(206)

Note 1: Business income

	Rs. '000	Rs. '000
	+	-
Profit before tax	5,900	
Less:		
Interest income from treasury bills → investment income		1,900
Rent income (ticketing agency (760 * 12)) → investment income		9,120
Dividend income (net) → investment income		3,000
Rent income (shopping arcade (240 * 12)) → effectively connected to the hotel business → no adjustment		-
Cash prize awarded by the Hotels Corporation → gift received in respect of business → liable to tax → no adjustment		-
Add/less:		
Book depreciation → disallowed under Section 10	6,250	

Provision for gratuity	5,200	
Management fees (Rs. 8 million) → claimable → no adjustment under Section 11	-	-
Guest entertainment → claimable → no adjustment under Section 11	-	-
Employee entertainment → disallowed	500	
Staff training → leading to diploma → domestic expense under Section 10	900	
Repairs to building → disallowed → related to investment income	350	
Office maintenance → allowed → no adjustment	-	-
Director's fee → WHT not deducted under Section 10	1,700	
Cutlery, crockery and glassware → allowed as not held for more than 12 months → no adjustment	-	-
Donation to the Ministry of Tourism	1,434	
Amount of interest paid = 4,800		
Amount of interest allowed = (SC + Reserves) * 4 = $\frac{4,800}{80} * ((2 + 16) * 4) = \underline{(4,320)}$		
Amount disallowed and carried forward to the next year = <u>480</u>	480	
Depreciation allowances:		
Kitchen equipment Y/A 2018/19 = 2,900		
Less: Kitchen equipment not used as at 31 March 2019 (not entitled to claim, assumed out of 2018/19 acquisitions) = <u>(1,500)</u>		
Claim of depreciation over 5 years = <u>1,400</u>		
Claim of depreciation over 5 years = 280		280
Kitchen equipment Y/A 2017/18 (Rs. 2.4 million at the rate of $33\frac{1}{3}\%$)		800
Motor car used for tourist hire (Rs. 6,000 over 5 years)		1,200
	22,714	16,300
	6,414	
Less: Business losses brought forward	(2,834)	
Business income	3,580	

Note 2: Tax rate applicable to the company

	Rs. '000
Gross turnover (accommodation, foods & beverage, tour transport and bar)	120,000
Other income	17,600
Gross income	137,600
Gross income from tourist undertaking	120,000
As a %	87%

The company is predominantly engaged in the business of tourism (more than 80% of the total income is from tourism). Hence the 14% tax rate is applicable on the taxable income.

Note 3

	Rs. '000
WHT on rent (12,000 * 10%)	1,200

(Total: 25 marks)

Answer 07

Relevant learning outcome/s: 2.1, 3.1, 5.1, 5.3

2.1 Dividend tax

3.1 Partnership

5.1 Value Added Tax (VAT)

5.3 Economic Service Charge (ESC)

Study text reference: Pages 26, 35, 39, 58 and 69

- (a) (i) A partnership is an association of two or more individuals or corporations carrying on business jointly for the purpose of making profit, irrespective of whether the association is recorded in writing (Section 195).

(ii)

Pretty Woman Partnership Withholding tax payable for the year of assessment 2018/19

		Rs.
Profit before tax		3,326,000
Less: Dividend income – investment income		(172,000)
Add: Partners' salaries		3,000,000
Salary to partner's son	Allowed	-
Loan interest (paid to partner)		80,000
Rent (paid to partner)	Allowed	-
Business income		6,234,000
Add: Investment income – dividend income		-
WHT deducted		-
Partnership income allocated to partners		6,234,000

	Meena	Neela	Leela	Total
Partners' salaries	2,000,000	1,000,000	-	3,000,000
Loan interest	-	-	80,000	80,000
Share of profits	<u>1,261,600</u>	<u>1,261,600</u>	<u>630,800</u>	<u>3,154,000</u>
	<u>3,261,600</u>	<u>2,261,600</u>	<u>710,800</u>	<u>6,234,000</u>
WHT @ 8%	260,928	180,928	56,864	498,720

(b) (i)

Output tax		Rs.		Rs.
Salon services		7,200,000	15%	1,080,000
Sale of cosmetics		2,700,000	15%	405,000
Educational services (diploma courses)	Exempt	3,850,000	-	-
		13,750,000		1,485,000
Input tax				
Import of cosmetics			276,000	
Local purchases of			145,000	

cosmetics				
Transport facility			7,500	
Common expenses		168,000		
Less: Disallowed input tax attributable to exempt supplies	$\frac{3,850,000}{13,750,000} * 168,000$			
	13,750,000	(47,040)	120,960	
Claimable input tax			549,460	
Debit note			2,600	
Total input tax			552,060	
Subject to 100% of output tax on taxable supplies	Rs. 1,485,000 or Rs. 552,060			(552,060)
VAT payable				932,940
Instalments paid				(800,000)
Balance VAT payable				132,940

(ii)

	Rs.
Salon services	7,200,000
Sale of cosmetics	2,700,000
Educational services	3,850,000
Liable turnover	13,750,000
Rate	0.5%
Economic service charge	68,750

(c) (i) (1) As SH has utilised the net dividend received, there is no WHT to be deducted on the dividend distribution made.

(2) The bonus share issue in March 2019 is considered as dividend per the Section 195 interpretation given on dividend. Accordingly, SH is liable to deduct and pay WHT at the rate of 14% on the capitalised part of the profit by way of a bonus share.

Bonus share issue = Rs 2,000,000 * 14% = Rs. 280,000.

(ii) (1) Not applicable

(2) On or before 15 April 2019

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