THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC 3 - Corporate Taxation

June 2019

Answer 01

Relevant Learning Outcomes: 2.1.3/2.1.4/2.2.1/5.4

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

In terms of section 4 of the IRA a non-resident person is liable to pay tax in Sri Lanka on its income from employment, business, investment or other source for that year, to the extent that the income arises in or is derived from a source in Sri Lanka. Based on the information provided, Heera has received both business income as well as investment income from Sri Lanka.

Sri Lanka has entered into a double tax treaty with India ("DTA"). Article 7 of the DTA provides that, the profits of an enterprise of one Contracting State will only be taxable in the other Contracting State, where such enterprise carries on business in that other State through a permanent establishment ("PE") in that other State. If the enterprise creates a PE in that other State, the profits of the enterprise attributable to such PE will be taxed in that other State.

Article 5 of the DTA provides the definition of a PE. Based on Article 5(5) of the DTA, Heera is deemed to have a PE in Sri Lanka as Saliya Enterprises (Pvt) Ltd is acting on behalf of Heera as its dependent agent. The services provided by Saliya Enterprises (Pvt) Ltd is on behalf of Heera and is controlled by Heera. As such Heera is deemed to have a PE in Sri Lanka and will be liable to pay income tax on the income attributable to the PE in Sri Lanka as a non-resident person.

(b)

		LKR
Net profit	49,100 x 175	8,592,500
Less:		
Gain on sale of quoted shares. Exempt income - (as per 3rd Schedule of the IRA)	450 x 175	(78,750)
Assessable Income from business		**8,513,750**
Taxable income		**8,513,750**
Income tax payable	**8,513,750**@ 28%	**2,383,850**
Remittance tax payable	(8,592,500 - 2,383,850) @ 14%	**869,211**

(c)(i)

Section 84(1)(a) provides that income tax on "royalty" will be payable by deducting withholding tax. The withholding tax rate as per the First Schedule to the IRA applicable to royalty is 14%. Therefore, a company in Sri Lanka is obliged to deduct withholding tax at 14% when making the payment of royalty to Heera Ltd.

However, as per Article 12 (2) of the DTA with India;
"However, such royalties or fees for technical services may also be taxed in the Contracting State in which they arise, and according to the laws of that State, but if the beneficial owner of the royalties or fees for technical services is a resident of the other Contracting State the tax so charged ***shall not exceed 10 per cent*** *of the gross amount of the royalties or fees for technical services."*

Accordingly, as per the above Article the withholding tax rate should be limited to 10% of the gross royalty when making royalty payments to a company in India.

(ii)

In terms of section 4 of the IRA a non-resident person is required to pay income tax on income that "arises in or is derived from a source in Sri Lanka". Section 73 of the IRA provides a list of payments that have a source in Sri Lanka. Section 73 (1)(c) provides;
"interest, charges, annuities, ***a royalty,*** *technical service fee or similar payment if –*
(i) paid by a resident person, other than as expenditure of a business carried on by the resident person through a permanent establishment outside Sri Lanka.

According to the above definition, as the royalty payments are made by companies in Sri Lanka which are resident persons in Sri Lanka, these payments are considered as having a source in Sri Lanka. As such Heera will be required to pay income tax on such income in Sri Lanka.

However, Article 12(2) is not applicable in the case of Heera since in terms of Article 12(4) of the DTA;
"The provisions of paragraph 1 and 2 shall not apply if the beneficial owner of the royalties or fees for technical services being a resident of a Contracting State, ***carries on business in the other Contracting State in which the royalties or fees for technical services arise, through a permanent establishment situated therein****, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties or fees for technical services are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply."*

As explained in point 1(a) above, Heera is deemed to have a PE in Sri Lanka through which it carries on business in Sri Lanka. As such, Article 12(2) is not applicable to Heera. Therefore, the applicable tax rate on the Royalty income of Heera Ltd is 28%.

(d) (i) In terms of sections 69(1)(b) and 70(1) of the IRA an "individual" who is present in Sri Lanka during the year and that presence falls within a period or periods amounting in aggregate to 183 days or more in any twelve month period that commences or ends during the year, such individual is considered to be a resident for income tax purposes from the start of the 183 day period. In terms of section 4 of the IRA a "resident person" is liable to pay income tax in Sri Lanka on his income from employment, business, investment or other source, wherever the source arises. As such Mr. Mahesh will be considered a resident person for tax purposes from the day he arrived as he has been in Sri Lanka for more than 183 days in any 12 month period and he will be liable to income tax in Sri Lanka on his global income.

However, the Article 15(2) of the DTA specifies that even though a resident of India exercised his employment in Sri Lanka, his employment income will only be taxed in India if all of the following criteria are satisfied;

(a) the recipient is present in that other Contracting State (i.e. Sri Lanka) for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned ; and
(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other Contracting State ; and
(c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in that other Contracting State.

As Mahesh is present in Sri Lanka for more than 183 days, and his remuneration is borne by the PE in Sri Lanka he will be liable to income tax in Sri Lanka on his employment income derived from the services he provided in Sri Lanka. As such he will be required to pay income tax in Sri Lanka on USD 3,000.

(ii) Mahesh being an expert on the technical aspects of the Diamond cutting machines, has used his knowledge to earn a profit of USD 5,000 from this transaction. He has only made one purchase and one sale during the entire period of 195 days. According to section 3 and 4 of the IRA, Mahesh is required to pay income tax on his income from business. Section 195 defines "business" to include "a trade, profession, vocation or **isolated arrangement with a business character however short the duration of the arrangement**". As such the transaction done by Mr. Mahesh can be considered to be a "business" and the profit of USD 5,000 from such business will be liable to income tax in Sri Lanka.

Further, in the case of *CIR vs. Livingstone*, a ship repairer, a blacksmith and a fish sales employee purchased as a joint venture a cargo vessel with a view to converting it into a steam ship drifter and to sell it. They were not connected in business and they had never previously bought a ship. Intensive repairs and alterations were carried out to make the ship marketable. It was held in this case that the transaction was an adventure in the nature of trade. In this case, an isolated purchase and sale of a ship was held to be a trading transaction as they embarked on activities to make the subject matter marketable.

As such the activity done by Mahesh in purchasing the old diamond cutting machine from a Sri Lankan company, which was repaired/modified and re-sold to another Sri Lankan company is considered as a business income and the profit of USD 5,000 is subject to income tax in Sri Lanka.

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes: 4.1/ 4.3, 6.4, 3.1.1/3.1.2

(a)

Accessories Lanka (PVT) Limited	**TIN:123456789 7000**			
CALCULATION OF VAT				
For the quarter ended 31 March 2019				
	Rs. '000			
	Turnover	**Exempt / excluded**	**Liable**	**VAT**
Revenue				
Normal sales	105,180		105,180	15,777
SVAT sales	254,390	-	254,390	38,159
Interest income	1,090	1,090	--	-
Profit on Sale of a Fixed Asset	800	800		-
Rent income	2,400	-	2,400	360
Sundry income	125	-	125	19
Sale proceeds of fixed asset **(Note 01)**	1,500	-	1,500	225
Total output VAT				**54,540**
Input VAT				
Imports		18,708		
Local purchases		8,662		
		27,370		
Less: Disallowable input tax		(420)		
Allowable input tax (Note:02)		**26,950**		**(26,950)**
VAT payable				27,590
Tax Credits				
SVAT credit vouchers				(38,159)
VAT payable /(refund)				**(10,569)**
Note (1)				
Cost of assets sold		2,800		
Book depreciation		(2,100)		
TWDV		700		
Book profit		800		
Sales proceeds		1,500		

Note (2) Allowable Input tax	
Zero rated/SVAT Supplies = Input Tax X SVAT Sales / Total Sales = 26,950 X 254,390 / 363,595	**18,856**
Not belonging to above = 26,950- 18, 856	**8,094**

(a) Internal memorandum

To Board of Directors of ALPL,

According to the provisions of section 178 of the Inland Revenue Act (IRA) No. 24 of 2017, if a person fails to file an income tax (IT) return on or before the due date, he shall be liable to pay a penalty equal to the greater of,

(a) 5% of the amount of tax payable as per return plus 1% of the tax due for each month or part of the month;
and
(b) LKR 50,000 plus a further LKR 10,000 for each month or part of a month However, such penalty is limited to LKR 400,000.

The late filing of income tax return has no impact on time bar provisions.
Section 135 of the Inland Revenue Act (IRA) No. 24 of 2017 deals with the time bar provision to make an assessment or additional assessment.

- The Assistant Commissioner may amend a self-assessment within 30 months from the date that the self-assessment return is furnished.
- The Assistant Commissioner may further amend the original assessment within 4 years from the date of filing the self-assessment
- Therefore, the time bar provision applicable for self-assessment is 4 years from the date that the self-assessment return is furnished.
- If the return has not been submitted, a default assessment may be made at any time.

(c) In terms of Section 139 -

A taxpayer who is dissatisfied with an assessment may request the Commissioner-General to review the decision. - Section 139(1)

A request for administrative review must be made to the Commissioner-General in writing not later than thirty days after the taxpayer was notified of the decision and shall specify in detail the grounds upon which it is made. - Section 139(2)

However, the taxpayer may request the administrative review even after 30 days if such delay is due to absence from Sri Lanka, sickness or other reasonable reason. - Section 139(8)

Where the objection is against an assessment which has been made in the absence of a return required to be made, the notice of objection must be sent together with a return duly made. - Section 139(3)

A person aggrieved by the result of a review under administrative review under section 139, may appeal against the assessment to the Tax Appeal Commission. - Section 140(1)

(2) An appeal to the Tax Appeal Commission may not be made unless a request for administrative review has first been made, and

(a) a decision has been received from the Commissioner-General; or
(b) ninety days have elapsed since the request for administrative review was made.

Section 140(2)

Either party to a proceeding before the Tax Appeal Commission who is dissatisfied with the decision of the Tax Appeal Commission may, within one month after being notified of the decision, file a notice of appeal with the Court of Appeal; and the party so appealing must serve a copy of the notice of appeal on the other party to the proceeding before the Tax Appeal Commission. Section 140(2)

An appeal to the Court of Appeal may not be made unless an appeal request to the Tax Appeal Commission has first been made, and

(a) a decision has been received from the Tax Appeal Commission; or
(b) ninety days have elapsed since the request for appeal to the Tax Appeal Commission was made and no response to the request for appeal has been received from the Tax Appeal Commission

An appeal from a decision of the Tax Appeal Commission to the Court of Appeal may be made only on a point of law. Section 140(2)

Answer 03

Relevant Learning Outcomes: 1.1/1.2, 4.4,5.3,3.3

(a)

Colombo Beverage and Confectionery (Pvt) Ltd
TIN: 123456789
Year of Assessment 2018/2019
Computation of Income Tax Payable
Based on the Unaudited Accounts for the Financial Year Ended 31 March 2019

	Notes	**Rs '000**
Net profit before taxation (per accounts)		**3,467,431**
Add		
Service Fee paid to Brand ambassadors - has not been deducted - U.S 10 (2) Disallowed as WHT		8,975
Cost relates to tour Inspect bottling plant - allowed - U.S 11 Foreign tour to inspect bottling plant Rs. 800,000- Allowed		
Personnel travelling Rs.300,000 - Disallowed as domestic expense of CBC Field visit vehicle used for private Travelling - Rs 25 per Km has to be considered for PAYE tax. if not 12000 x 25 such expenditure will be disallowed as domestic expenses - U.S 10		300
Compensation Paid – Allowed		-
Accounting Loss of the Offshore Business Unit		59,840
Provision for gratuity - U.S 10 (b)		190,000
Sundry Expenses - Domestic expenses - U.S 10		5,400
CSR Expenses - U.S 11		7,600
Depreciation -		78,500
Amortization of Intangible asset - Disallowed - U.S 10		404
Amortization of Lease rental paid in advance - allowed as based on actual lease period		-
Interest allowed U.S 18	**2**	-
		351,019
Less: Other sources of Income / Final Withholding Payments		
Dividend Income (Net) - Final Tax / Exempt		(1,340,612)
Rent Income - From commercial building taxed separately as investment income - U.S 7 Total rent Income = Rs. 52,800 Less: Lorry given on rent - Business Income = (Rs. 2,400) Balance investment income = **Rs. 50,400**		(50,400)
Rent Income from lorry Rs. 2,400 - business Income as effectively connected to business - U.S 6		-
Realized Gain from forgone lease right - Tax separately as investment income - U.S 7		**(5,350)**
Money received for accepting a restriction / condition on prospective business - Taxable - S. 6		-
Change in value of IP- Disallowed - U. S 10		(21,360)

Gratuity Paid	**3**	(418,049)
Depreciation allowances	**4**	(74,300)
Interest from Treasury Bills (Net) - Tax separately under investment income		(60,917)
Interest income from short term deposits		(44,000)
		(2,014,988)
Assessable Income from Business before deducting business loss		**1,803,462**
Less :Tax loss of the Offshore Business Unit - 100% deductible		
B/ F Loss - Cannot be claimed	**1**	**-**
Add : During the Year Loss	**1**	(62,080)
Assessable Income from Business		**1,741,382**
Interest income		104,917
Rent Income		50,400
Realized Gain from forgone lease right Compensation Received = Rs. 12,000 Less: cost of the acquisition of lease right less the amount amortised in 17/18 = (Rs. 6,650)		5,350
Investment income		**160,667**
SUMMARY OF SOURCES OF INCOME		
Assessable Income From Business		1,741,382
Assessable Income From Investment		160,667
Total Assessable income		**1,902,049**
Less: Qualifying payments & Relief U.S 52		
Donation made to government		(7,600)
Taxable income		**1,894,449**
Income tax liability		
Realized Gain from forgone lease rights - capital gain tax at 10%5,350 x 10%		**535**
Balance Taxable Income 1,889,099x28%		528,948
		529,483
Less: Tax Credits		
WHT paid Rent Income (Gross) 52,800 x 10% = 5,280 Interest income from short term deposits=44,000x 5% = <u>2,200</u> **<u>7,480</u>**		(7,480)
ESC paid		(244,762)
Balance tax payable		**277,241**

Note 1 - Calculation of Tax Loss of Offshore Business Unit				
Brought forward loss				
Up to Y/A 2017/18 Offshore business unit was exempt U.S 13 from tax. However under the new act such exemption is not available.			27,320	
Current Year Loss				
Net Loss of offshore business unit as per books			(59,840)	
Add: Accounting Loss on disposal of office furniture			8,600	
Less: Balancing Allowance				
Sales proceed		6,240		
Less : TWV	85,400 - (85,400 x 20% x 4)	(17,080)		
Loss from disposal /Balancing Allowance			(10,840)	
Tax Loss of Offshore Business Unit			(62,080)	

Note 2 - Finance Cost	
Bank Loan Interest	78,932
Lease interest	360
Bank Overdraft Interest	148,500
	227,792
Finance Cost	227,792
Total Borrowings (long term & short term & OD)	1,975,525
SC + Reserves	9,693,982
Three times of the SC + Reserves (as CBC is a manufacturer company)	29,081,946
As three times of the SC + Reserves are much higher than the total borrowings the full interest cost is allowed for tax purposes	

Note 3 - Gratuity Paid	
Opening balance a at 01/04/2018	571,353
Add: Provision for the year	190,000
Add: Actuarial gain	18,562
Total	779,915
Closing balance As At 31/03/2019	361,866
Gratuity Paid	418,049

Note 4 - Depreciation Allowance for the year 2018/2019				
Description	**Year of Purchase**	**Cost**	**Rate**	**Amount**
		LKR	**%**	**LKR**
Soft Drink Plant	2017/18	153,900	33.33%	51,300
Automated machinery	2018/19	107,000	Over 5 Yrs	21,400
Motor Lorry - Freehold Asset	2018/19	3,000	Over 5 Yrs	600
Motor Lorry - Leasehold Asset	2018/19	3,000	Over 5 Yrs	600
Building -	2018/19	8,000	Over 20 Yrs	400
Motor Cars - Cannot be claimed (assumed motor vehicles purchased in Y/A 17/18 are motor cars)				-
Total		123,648		**74,300**

(b) (i) CBC is engaged in the business of manufacturing carbonated soft drinks and frozen confectionery for the Sri Lankan market and for the export market. Further there is an overseas sales outlet in Maldives to sell the products manufactured by CBC.

1. **Amount declared as taxable supply**
As per the provisions of the VAT Act, amount declared as taxable supply is correct and the Assistant Commissioner has not made any dispute on the same.

2. **Amount Declared as zero-rated supply**
CBC has declared the goods sent to offshore business unit i.e. in Maldives as zero-rated supply. In terms of section 7(1)(a) of the VAT Act where the supplier has exported goods such goods are zero rated. Hence the Assistant Commissioner's contention is incorrect.

3. **Amount Declared as exempt supply**
CBC has correctly declared the sale of Yoghurt and curd as an exempt supply as in terms of item (xxvi) of paragraph (b) of Part II of the First Schedule to the VAT Act "*locally produced dairy products out of locally produced fresh milk in so far as such milk is produced in Sri Lanka and locally produced rice products containing rice produced in Sri Lanka* is exempt from VAT. Therefore, the Assistant Commissioner's contention is incorrect.

4. **Claim of Input Tax**
In terms of section 22 of the VAT Act, input tax is deductible only in respect of expenditure attributable to taxable supplies and not on exempt or excluded supplies.

   Accordingly, the company cannot claim any input tax in respect of the expenses attributable to exempt supplies (Yoghurt and curd). Hence in preparing the VAT return the relevant portion of input tax has to be disallowed.

Therefore, the Assistant Commissioner's intention is correct.

(ii) **Validity of the Assessment**

If a person has filed the return on the due date or where a person has been assessed for tax in respect of any period, it shall not be lawful for the Assistant Commissioner to make an assessment or make an additional assessment, as the case maybe, **after the expiration of 3 years from the end of the taxable period** for which returns were furnished or the assessment was made, as the case maybe.

CBC has filed the return on time hence time bar provision is applicable. Accordingly, CBC can take up the position that the assessment has no legal validity.

(c) (i) Recognise the cost incurred in Maldives as research and development expenditure**.**

As per the Inland Revenue Act No. 24 of 2017 (hereafter referred as IRA) which was effective from April 01, 2018 the following can be noted in relation to the deduction of research and development expenses.

As per the section 15 of the Act,

"research and development expenses" means expenses incurred by the person in –

(a) carrying on any scientific, industrial, agricultural or any other research for the upgrading of the person's business through any institution in Sri Lanka (or for any innovation or research relating to high value agricultural products, by the person or through any research institution in Sri Lanka); or

(b) the process of developing the person's business and improving business products or process,

which shall be beneficial to Sri Lanka but shall exclude expenses incurred that are otherwise included in the cost of an asset under this Act.

In terms of item 8 of the Sixth schedule (Temporary concessions) to the Act,

A person is entitled to an additional deduction when calculating the person's income from business for a year of assessment equal to 100% of the total amount of research and development expenses deducted for the year under section 15, for three years of assessment after the commencement of this Act.

Accordingly, **<u>if expenditure incurred by the Maldives Unit falls within the category of research and development expenses</u>** as specified above, CBC is entitled to claim 200% of such research and development expenses up to the Y/A 2020/2021 for tax purposes.

The most important facts related to the said decision of the Chairman is to be considered as follows;

- The sales outlet has operated since its inception with a profit motive even though it is set up to promote the sports brand. It was mentioned that this decision was taken as a result of incurring continuous losses.

- To avoid the loss situation the sudden change of the company's accounting policy (as per pre-seen) could not be treated as R&D expenses since the previous year's treatment for tax purposes could be different from this. On the other hand as per the provisions of the Act; there is no indication that it had any beneficial effect to Sri Lanka and there was no evidence of any process improvement.

  The previous years' loss on operations could have already been taken into consideration for such years of assessments. Therefore, it cannot be considered as R&D expenses since it does not have the characteristics to prove it falls under R&D expenses.

(ii) **Buy Back of Shares at fair value**

In terms of the section 195 of the Act dividend is defined as below:

"dividend"–

(a) means a payment derived by a member from a company, whether received as a division of profits, in the course of a liquidation or reconstruction, in a reduction of capital or ***share buyback*** *or otherwise;*

(b) includes a capitalisation of profits –
- *(i) whether by way of a bonus share issue, increase in the amount paid-up on shares or otherwise; and*
- *(ii) whether an amount is distributed or not; and*

(c) excludes a payment to the extent to which it is –
- *(i) matched by a payment made by the member to the company;*
- *(ii) debited to a capital, share premium or similar account; or*
- *(iii) otherwise constitutes a final withholding payment or is included in calculating the income of the member*

Accordingly buy back of shares falls within the meaning of dividend and the **difference between fair value less cost is considered as dividend**, liable to **dividend tax at 14**%.

Accordingly, buy back of shares at fair value creates a tax exposure.

(iii) **Distribution of dividend**

In terms of section 84 and paragraph 10 of the first schedule of the IRA, distribution of dividend is liable to withholding tax at 14%.

If the dividend distribution occurs after April 1, 2019 dividend is liable to withholding tax at 14% even CBC utilizes the net dividend received for such distribution.

However as per gazette No. 2064/53 on transitional provision,

In case of any dividend paid to a shareholder of any company prior to April 01, 2019, out of any such dividend received by that company from any other company on which tax had been deducted prior to April 01, 2018 in accordance with the provisions of the Inland Revenue Act, No. 10 of 2006, such dividend shall not be subject to tax under the provisions of the Inland Revenue Act, No. 24 of 2017.

Therefore, if the dividend is distributed prior to 1 April 2019 out of the dividend received by the company from which 10% had been deducted and no further tax is payable on such dividend.

It is clear that the net dividend received during the YA 2017/18 was not utilized to distribute dividends in the YA 2018/19. Therefore, it is not entitled to the concession under transitional provisions. Since the suggested distribution occurred in the YA 2019/20 such dividend is liable to WHT at 14%**.**

(d) (i) **Gift Received by David Scott**

In terms of items (d) and (i) of section 5 (2) of the IRA,
(d) payments for the individual's agreement to conditions of employment;
(i) other payments, including gifts received in respect of the employment;
will be gains and profits from employment of an individual for a year of assessment.

Accordingly, any special payment received by David Scott for not withdrawing any funds for his personal expenses as other directors and for agreeing to allow the company to buyback his shares at cost instead of at fair value is subject to tax in his hand as gains and profits from employment.

Further, as per the case Kanagasbapathy Vs Commissioner General of Income Tax, it was held that the benefit conferred to the employee is liable to tax as profit from employment if it can be established that the benefit is received in return for acting or being an employee and receives it in respect of employment.

(ii) **Repair and Improvement cost on waste water plant**

In terms of section 14 of IRA, expenses for the repair or improvement of depreciable assets incurred during the year in the production of income is deductible irrespective of whether they are of a capital nature or not, subject to a limitation of,

- in the case of repair or improvement to buildings, structures and similar works of a permanent nature, five percent of the written down value of the asset at the end of the previous year. In all other cases, twenty percent of the written down value of the asset at the end of the previous year. (Section 14)

Excess expense for which a deduction is not allowed as a result of the limitation can be added to the depreciation base of the asset.

As the waste water plant is a depreciable asset used in the production of income any repair and improvement cost incurred during the year of assessment including any capital expenditure is allowable subject to a limitation of twenty percent of the tax written down value of the asset at the end of the previous year.

According to the given facts it is clear that this particular machinery was purchased before 1st of April 2018 and is fully depreciated for tax purposes. On the other hand as this machinery was purchased before 1/42018 the provisions related to repairs and improvements under the new Act will not be applicable. Therefore, the total expenditure is to be allowed if it is considered as revenue expenditure**.**

As per the case "Theobald vs Commissioner of Income Tax" it was held that any expenditure incurred which would result in an 'enduring benefit', is of capital nature. Therefore, if this 45 million worth of repairs and improvements is treated as capital nature, then no deduction shall be allowed.

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