

CA



THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

15304 – Advanced Taxation and Strategic Tax Planning

CA Professional (Strategic Level I) Examination
December 2014

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Answer No. 01

(a)

ASIAN Construction PLC

Computation of statutory/assessable/taxable income and tax payable

Adjusted profit from trade (Schedule 01)			1,672,850	
Profit on sale of CSE shares			Exempt	
Interest income				
Interest on staff loan		6,000		
Fixed deposits (90,000/90 x 100)		90,000		
Treasury bills (112,000/90x 100)		124,444	220,444	
Total statutory income			<u>1,893,294</u>	
Less: Trade losses				
B/f infrastructure project loss		750,000		
As it is exempt from tax deduction not allowed		-	-	
Assessable Income			<u>1,893,294</u>	
Less: Q/P				
Donation to sick & needy (Limited to 1/5 of AI or Rs. 500,000 lower)		7,000,000		
Allowed lessor amount of Rs. 500,000			(500)	
Expansion - Construction machinery	480,000			
Limited to 25%	<u>(120,000)</u>		-	
As construction income is exempt, Qualifying Payment is not available.				
Taxable income			<u>1,892,794</u>	
Tax Payable	On income	<u>1,892,794</u>	28%	<u>529,982</u>
		<u>1,892,794</u>		529,982
	<u>On dividends</u>			
	Interim dividend		128,000	
	Less: Div received		<u>(17,000)</u>	
			111,000	
	Less: Distributed out of exempt profit			
	<u>1,250,000</u>		<u>(47,470)</u>	
		x 111,000		
	2,922,850		<u>63,530</u>	
			10%	<u>6,353</u>
Total tax liability				<u><u>536,335</u></u>

Schedule 01

Computation of adjusted Profit From Trade

	+	-
Net profit before tax	3,122,038	-
Less: Dividend Received	-	17,000
Gain on FV changes in Unit Trust (No other adjustment due)		210
Profit on sale of shares		428
Profit on sale of fixed assets		400
Interest on fixed deposits		90,000
Interest on treasury bills		112,000
Interest on staff loans		6,000
Disallowed and allowed items		
Valuation fees	2,000	
Interest on finance lease	12,000	
Depreciation	57,000	
Entertainment	14,000	
Advertisement 25% disallowed 24,000	6,000	
Provision for bad debts	68,500	
Recovery of bad debts		
(Adjustment needed as provision allowed earlier)	18,000	
Provision for gratuity	9,750	
Gratuity paid		4,300
Foreign travel expenses	37,000	
Allowed: 2% of Pr. Yr. profit 1,450,000 <u>(29,000)</u>	8,000	
Donation	7,000	
1 st time adoption - Allowed in three years equal instalments		4,000
Adjusted profit/(loss) from disposal of machinery	167	
Lease rentals paid (limited to $\frac{1}{5}$ of lease value or actual payment)		9,600
Capital allowances: construction machinery	480,000	
Less: disposed machinery	<u>(7,000)</u>	
@ 33 $\frac{1}{3}$ %	473,000	
	<u>3,324,455</u>	<u>401,605</u>
Adjusted profit from trade	2,922,850	
Less: Adjusted profit of exempt income	<u>(1,250,000)</u>	
	<u>1,672,850</u>	

Note 01

Adjusted profit from disposal of fixed assets

Sale proceeds		2,500	
Tax WDV			
Cost	7,000		
Depreciation claimed	<u>(4,667)</u>		
		<u>(2,333)</u>	
Profit from disposal		167	

Note 02

Lease rental allowed

Leased value	48,000	
1/5 of total lease	9,600	} lower
Payment of lease rent	12,000	
Allowed	9,600	

Computation of distributable profit

Net profit before		
Tax		3,122,038
Less: Income tax		<u>(529,982)</u>
		2,592,056
Add: Dep ⁿ on F/A acquired during the year		
36,000 12% 4,320		
As lease asset is not treated as an acquisition of FA, no need to adjust depreciation on such asset.		<u>-</u>
		2,592,056
Less: FA acquired during the year (leased asset)		<u>-</u>
Distributable profit		<u><u>,592,056</u></u>
Minimum 10% distribution to be made		259,206

Alternative answers for tax on dividends

The undermentioned treatment is also acceptable based on the following assumptions.

Assumption 1

If dividend is paid wholly out of exempt income, then no dividend tax is payable as it is exempted under section 10K

Assumption 2

If dividend is paid wholly out of liable income, then entire dividend is liable to dividend tax.

(25 marks)

- (b) Under Section 17A, any new undertaking engaged in the manufacture of construction material on or after 1/4/2011 is exempt for a period of 5 years provided such undertaking has invested the minimum amount specified in the Schedule to Section 17A.

Even though the company is engaged in the business of manufacturing of ready mix concrete, such an undertaking is not a new undertaking as defined in Section 17A. Therefore manufacture of ready mix concrete is not entitled to income tax exemptions under section 17A.

(5 marks)

(Total: 25 marks)

NOT FOR SALE

Examiners' comments

Part (a) There were many good answers to this corporate income tax question. Most candidates had displayed excellent skills in the construction and identification of the statutory contents of the income tax computation. Majority of the candidates demonstrated sound subject knowledge in the application of tax law in relation to the undermentioned areas:

- Sections 25 and 26 of the Inland revenue Act - allowable and disallowable items.
- Computing the statutory income from different sources.
- Deduction under Section 32
- Section 34 – qualifying section

Most of the candidates had demonstrated sound knowledge in computing distributable profits and the minimum amount of dividend to be distributed.

Where mistakes were made, these generally related to:

Improper reading of the question

- (i) First time adoption of SLFRS – the question clearly states that the costs were incurred in the Y/A 2012/13. A good number of candidates disallowed the total cost in the Y/A 2013/14 computation.
- (ii) The question required the candidates to compute the income tax liability of the company. A majority of the candidates claimed applicable tax credits (e.g. PAYE) and computed the net tax liability. Obviously this is waste of valuable exam time earning no extra marks.

Lack of subject knowledge

- (i) First time adoption of SLFRS – majority of the candidates were not aware that one third of the total cost can be claimed as a tax deduction in each of the three years of assessment.
- (ii) Advertisement - a few candidates disallowed 75% of the cost.
- (iii) Lease rental claimable – a good number of candidates were not aware that the claim is limited to 1/5th of the total lease value.
- (iv) Exemption of profits of new undertakings for infrastructure development – majority of the candidates failed to identify the profit exempt from income tax.
- (v) Majority of the candidates were not aware that a lease, had it been a profit exempt from income tax, cannot be claimed as a deduction.

Computation of distributable profit

Although candidates correctly identified the contents of this computation, a good number of candidates failed to exclude leased assets and the corresponding book depreciation charge.

Part (b) Only a very few candidates furnished satisfactory answers to this strategic part of the question.

Answer No. 02**(a) Computation of the income tax liability of Dinuka for the Y/A 2013/14**

			Rs
Sources of income			
<u>Employment income</u>			
Salary (Rs. 150,000 x 9 months)			1,350,000
Retiring benefits (Note 02)			5,309,000
Housing benefit			
<u>Rental value</u>			
Rating assessment + rates =	475,000	}	
Rent paid by employer (30,000 x 9 months)	270,000		higher 475,000
		}	
			lower 120,000
Employment income is less than 1,800,000	120,000		
Less: Rent paid by employee (2,500 x 9 months)			(22,500) 97,500
Travelling allowance			
Travelling allowance in lieu of motor vehicle	60,000		
Exempt - Rs. 50,000 per month	(50,000)		
	10,000	x 9 months	90,000
Interest income			
Interest income does not form part of the assessable income as WHT is deducted	276,000		-
Income from trade - Agriculture	(Note 01)		2,805,500
Total statutory income			9,652,000
Less: Statutory deductions			
Interest paid on loan (Acquisition of agricultural property)			(1,800,000)
Assessable income			7,852,000
Tax free allowance			(500,000)
<u>Qualifying payments</u>			
Qualifying payment on employment income			(100,000)
Loan capital - not allowed			-
Donation - Sick & needy ($\frac{1}{3}$ of AI or Rs. 75,000 - Lower)			(12,000)
Taxable income			7,240,000

Less: ETF		1,659,000	
As uniform scheme entitle for exemption (More than 20 yrs)		5,000,000	<u>(1,659,000)</u>
			5,581,000

Computation of tax liability

	500,000	4%	20,000
	500,000	8%	40,000
	500,000	12%	60,000
Agriculture liable at max 12%	2,805,500	12%	336,660
	500,000	16%	80,000
	775,500	20%	155,100
	5,581,000		691,760

Less: Tax Credits

PAYE		(73,809)
S A Quarterly Payments		(130,000)
Balance tax payable/(refund due)		487,951

ETF Board retained	165,900	} Not a tax credit Tax direction to be obtained
Retained on gratuity	876,000	
	1,041,900	

Note 01**Income from trade - Agriculture**

		Rs.
Net profit as per accounts		2,936,000
Add: Disallowed expenses		
Advertisements 78,000 x 25%		<u>19,500</u>
		2,955,500
Less: Capital allowances		
Computer 80,000 x 25%		(20,000)
Tractor 650,000 x 20%		<u>(130,000)</u>
Adjusted trade loss		2,805,500

Note 02**Tax on terminal benefits**

Gratuity - (Non Uniform Scheme) 3,650,000

EPF

EPF on members contribution	2,592,000	Exempt
EPF on employers contribution	3,888,000	Exempt
Interest on EPF	1,360,000	Exempt

ETF

ETF contribution	1,472,000	
Interest up to 31/03/1987	<u>187,000</u>	1,659,000
Interest after 01/04/1987	522,000	Exempt

Taxable terminal benefits 5,309,000

(16 marks)

- (b) Dinuka is required to obtain a direction from the Department of Inland Revenue within 90 days from the retention of tax by the employer and the ETF Board. This direction which is issued by the Inland Revenue will set out the amount of tax to be deducted and when this direction is provided, the employer or the ETF Board will release the amount retained accordingly.

If no direction is received within 90 days, the employer and the ETF Board will remit such money to IRD.

(4 marks)

(Total: 20 marks)

Examiners' comments

Part (a) - most candidates made a good attempt at this question. There were some excellent answers. Majority displayed excellent skills in the construction and identification of statutory contents of an income tax computation of a resident individual. Most candidates demonstrated sound knowledge in:

- Identification allowable/disallowable items (SS.25 and 26 of the Inland Revenue Act)
- Identifying income from different sources
- Identifying S.32 deductions
- Claiming qualifying payments

Where mistakes were made, these generally related to:

Employment income

- Improper reading of the question
E.g. the tax payer retires from employment three months prior to the end of year of assessment. However, a good number of candidates computed employment benefits for twelve (12) months.
- Lack of subject knowledge.
E.g (i) Retiring gratuity was paid under a non-uniform scheme. However, a good number of candidates computed the tax liability on the basis that such payment was made under a uniform scheme.
(ii) Employment allowance – a few candidates were not aware this is a qualifying payment under S.34 with effect from Y/A 2013/14.
(iii) S.32 and S.34 deductions – a good number of candidates were not aware that no such deductions are allowed from employment income.

Income from trade

- A few candidates commenced from the turnover for the purpose of computing the adjusted trade profit. This is waste of valuable exam time earning no extra marks.
- Applying incorrect depreciation allowance rates.

Part (b) - Surprisingly, only a few candidates scored full or substantial marks for this part. As a matter of fact, more than 90% of the candidates did not attempt this question or failed to score any marks.

Few examples of answers submitted by candidates is given below;

- (i) File a case at the labour department to recover the monies retained by the company and ETF board.
- (ii) Set off the amounts against the income tax liability.

Answer No. 03

Pharmaceutical Association of Sri Lanka

Since the receipts from members who are entitled to claim deductions of the membership fees is more than 50% of the gross receipts, this Association is deemed to carry on a business.

Income - Business

	Rs.
Membership fees	6,000,000
Less: Expenses (Allowed in full)	<u>(4,875,000)</u>
Total trade income	<u>1,125,000</u>

Investment income

	Rs.	Rs.
Rent income		
Gross rent	2,400,000	
Less: rates	<u>(60,000)</u>	
	2,340,000	
Less: 25% repairs	<u>(585,000)</u>	1,755,000
Interest Income - Govt. securities		
Net	1,800,000	
Notional tax credit	<u>200,000</u>	<u>2,000,000</u>
Total other income		<u>3,755,000</u>

The association is liable to pay income tax on Business Income or Investment Income, whichever is more

Hence Other Income Liable = Taxable Income	<u>3,755,000</u>
Tax payable @ 10%	375,500
Less: Tax paid	
Notional tax credit	<u>(200,000)</u>
Balance income tax payable	<u><u>175,500</u></u>

Bank interest income and dividend income do not form part of total statutory income.

(Total: 10 marks)

Examiners' comments

This question can be considered as a bonus at the strategic level. Surprisingly, performance of a fair number of candidates was disappointing. However, a few candidates scored full marks.

The undermentioned mistakes made by candidates are noteworthy.

- Mixing up with the taxation of a club. A good number of candidates mentioned the basis appropriate to a club for the purpose of determining whether the association is deemed to carry on business.
- Treating interest income of government securities as final tax.
- A good number of candidates were ignorant of the provisions of the law relating to taxation of trade associations. They included both business income and investment income in computing taxable income.

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Answer No. 04

D.K. Industries (Pvt) Ltd
NBT computation for the quarter ended 31 March 2014

	Excepted	Liabe		
	Rs.	Rs.		
<u>On manufacturing income</u>				
Sales in Sri Lanka	-	3,800,000		
Export income	6,000,000	<u>-</u>		
		3,800,000	@ 2%	76,000
 <u>On trading income</u>				
Imported and sold locally		4,500,000		
Purchased from other members and exported	3,000,000	-		
Purchased from other members and sold locally		<u>2,000,000</u>		
		6,500,000		
Less: 50% of income		<u>(3,250,000)</u>		
		3,250,000	@ 2%	65,000
 <u>Distributor</u>				
Sales as a distributor		8,000,000		
Less: 75% of turnover		<u>(6,000,000)</u>		
		<u>2,000,000</u>	@ 2%	<u>40,000</u>
				181,000
Less: NBT paid on RM imported for manufacture	(40,000)			
Disallowed input paid at Customs (Note: 01)	<u>24,490</u>	(15,510)		
NBT on imports (Trade) Not Allowed		-		
NBT on raw materials		<u>(20,000)</u>		<u>(35,510)</u>
Balance NBT payable				<u>145,490</u>

Note 01

Disallowed input NBT

$$\frac{\text{Export sales}}{\text{Total Manuf. Sales}} \times \text{Input NBT on Imports} = \text{Rs. 24,490}$$
$$\frac{6,000,000}{9,800,000} \times 40,000 = \text{Rs. 24,490}$$

(Total: 13 marks)

Examiners' comments

Majority of the candidates made a good attempt at this question. A common area where a majority made mistakes was in relation to the computation of disallowable input NBT attributable to excepted turnover. The undermentioned weaknesses exhibited by candidates are noteworthy.

- Not categorising turnover as manufacturing, trading and distribution. This is important since these categories have different turnover losses for the purpose of taxation.
- Applying rates of taxing – e.g. 3%, 1%.
- Mixing with Value Added Tax (VAT). A few applied zero rate (0%) on export turnover.
- NBT rate is statutory and cannot be changed to suit specific needs. E.g. a good number of candidates applied different rates computed to recover the tax from the customers.

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Answer No. 05

Ambroso Rubber Estates (Pvt) Ltd

* The company is a resident company for the purpose of the Inland Revenue Act.

As double tax agreements are with Malaysia;		Tax rate	Tax payable
Profit adjusted for tax purposes	200,875,000	12%	24,105,000
Gross interest			
on Govt. Securities (45,000,000/9) x 10)	50,000,000	28%	<u>14,000,000</u>
Taxable Income	250,875,000		38,105,000
Less: Tax paid in Sri Lanka			
Notional tax credit (45,000,000/9) x 1			<u>(5,000,000)</u>
			33,105,000
Less: tax paid in Malaysia			<u>(80,350,000)</u>
Excess tax - limited to the extent of tax payable and not entitled to a refund			(47,245,000)

(Total: 12 marks)

Examiners' comments

Majority of the candidates made a poor attempt at this question. However, a good number of candidates identified the resident status of the company which is the key to answering this question. The reason for poor performance can be summarised as follows:-

- A fair number of candidates computed the income tax without mentioning the residence of the company.
- A good number of candidates mentioned that the interest received from government securities is exempt from income tax since withholding tax has been deducted.
- Some candidates added, while some deducted, the tax paid abroad to/or from the profit earned abroad and taxed the gross/net income.

Answer No. 06

- (a) Section 25 of the Inland Revenue Act permits deductions in respect of expenditure incurred in the production of income and outgoings. The cash lost is not an expense but is an outgoing as explained in the case of Chas P Hayleys Ltd Vs Commissioner of Inland Revenue. But an outgoing, in order to be deductible, should be of a revenue nature as it so happened in the case referred to in which the cash lost represented stock-in-trade which is part of circulating capital. But the cash lost in the present case represents the sale proceeds of a capital asset which is intended to be used for the purpose of acquiring a similar asset in place of the asset lost. Therefore, it is an outgoing of a capital nature deduction which is prohibited by Section 26 of the Act.

(5 marks)

- (b) The requirement under Section 163 (3) of the Inland Revenue Act is that the assessor should give reasons for the rejection of the return. But the purported reasons given by the assessor are not actually reasons but conclusions the assessor has reached on the basis of certain facts which facts themselves are the reasons. What the assessor should say is why he says that the creditors are fictitious, why he says that the rate of gross profit is low and why he says that the drawings are insufficient. Accordingly, the communication in question is not a valid communication of reasons under the relevant provisions (Authority – Mrs. D.M.S. Fernando Vs A.M. Ismail or New Portman Ltd Vs Jayawardene).

(5 marks)

- (c) The purpose of the transaction is to take the accumulated profits of the company into the hands of the shareholders without paying dividend tax. This kind of transaction is governed by Section 103 of the Inland Revenue Act which gives authority to the assessor to disregard artificial or fictitious transactions or disposition not in fact given effect to, for tax purposes. The present transaction is an artificial transaction which should be disregarded and the dividend should be assessed to tax. (Authority – Trustees of Seramco Super Annuation Fund Vs Commissioner of Income Tax Jamaica).

(5 marks)

(Total: 15 marks)

Examiners' comments

Parts (a) and (b) - The performance of a majority of candidates was above average and, in some cases can be considered as excellent. The ability of some candidates to identify the relevant case law having similar facts and the reasoning given in arriving at the conclusion (or judgment) was commendable. However, a fair number of candidates quoted irrelevant case law with dissimilar facts. For example, in answer to part (b), a few candidates mentioned the appeal procedure against an assessment.

Part (c) - A good majority of the candidates either did not attempt this part of the question or wrote irrelevant answers. Only a very few candidates identified the artificial or fictitious nature of the transaction.

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