

TR100

Facts

A Ltd is engaged in the provision of management services, including financial and human resource services to related companies. B Ltd which operates a Beach Resort Hotel is a related company in which A Ltd holds shares, representing 23% of the total shares. A Ltd derives management fee from B Ltd as a consideration for the service it provides to this company under a management agreement. There is, however, no formal written management agreement between the two companies.

Pursuant to a restructuring exercise, the management agreement between the two companies has terminated and consequently B Ltd has to compensate A Ltd. The compensation has been computed at some Rs 203 m and is based on an independent valuation. The consideration for the compensation will be by way of shares, so that B Ltd will issue new shares to A Ltd.

Points in issue

Confirmation that pursuant to the termination of the management agreement between A Ltd & B Ltd -

- a) the compensation payment that will be made by B Ltd (by way of issue of new shares) should be treated as capital income to A Ltd and therefore should be outside the tax net.
- b) in the event the compensation payment is capitalized in the books of B Ltd for accounting purposes and is depreciated, annual allowance at the rate of 15 % would be available to B Ltd on a straight line basis.

Rulings

- a) Facts provided show that there did not exist between the two companies a formal written contract agreement requiring the mandatory payment of compensation in the event of its termination, nor the amount thereof. Also, the management fee derived by A Ltd from B Ltd did not constitute a substantial part of the income of A Ltd for provision of such services to related companies, so that the termination of the said agreement did not fundamentally affect the structure of its business. It cannot therefore be confirmed that the compensation receivable by A Ltd is a capital receipt and therefore outside the tax net. It is a receipt of revenue nature constituting gross income under Section 51 of the Income Tax Act, and therefore subject to tax.
- b) On the basis of the ruling given at (a) above no annual allowance will be available to B Ltd.