TAXATION – BLOCK REVISION MOCK 14

QUESTION ONE

(a) Explain the meaning of the following terms as used in respective tax legislation:

Bond security	(2 marks)
Single business permit	(2 marks)
Customs bonded warehouse	(2 marks)
Stamp duty	(2 marks)
Tax free remuneration	(2 marks)

(b) Ukulima Savings and Co-operative Society Ltd. has presented you with the following income and expenditure account for the year ended 31 December 2005:

	Sh.	Sh.
Income		2,252,500
Rental income		424,000
Investment income – dividends		5,750,500
Interest from loans to members		747,300
Interest from Savings and Loans Kenya Ltd.		9,174,300
Expenses	443,875	
Traveling	236,910	
Printing and stationery	132,500	
Legal expenses	271,625	
Medical expenses for staff	4,253,350	
Salaries and wages	100,000	5,438,260
General office expenses		3,736,040
Net income		

Required:

(i) The taxable income for the year and tax payable. (8 marks)

(ii) Comment on any information not used in (i) above. (2 marks)

(Total: 20 marks)

QUESTION TWO

Mr. Kipkoech, a wealthy farmer from Uasin Gishu District has presented you with the following profit and loss account for the year of income 2005.

	Sh.	Sh.

Income		800,000
Disposal of entire poultry stock		3,000,000
Sale of other livestock and produce		1,500,000
Sale of all standing timber		175,000
Dividends from Uasin Dairy Society (net)		80,000
Interest from Co-operative Bank (net)		5,555,000

	Sh.	**Sh.**
Expenditure		
Clearing bush land for planting coffee	250,000	
Capital works to prevent soil erosion	240,000	
Purchase of pigs to replace the poultry	575,000	
Wages of labourers	465,000	
Wages of housegirl	60,000	
Purchase of seeds and fertilizers	590,000	
Rent of shed to store harvested crop	135,000	
Motor vehicle expenses	96,000	
Repairs to fence, dips and dairy shed	88,000	
Subscriptions to Usasin gishu sports Club	60,000	
Interest paid to bank on loan to finance	84,000	
planting	240,000	
Hailstorm damage to pyrethrum crop	80,000	
(insured)		
Insurance premiums against crop damage	120,000	
Depreciation:	420,000	
Dairy machines	144,000	
Tractors and lorries	68,000	
Salary of Mrs. Kipkoech	120,000	
Hire of pick-up for farm deliveries	40,000	3,875,000
School fees for son		1,680,000
Life insurance premium for Mr. Kipkoech		
Net profit before tax.		

Mr. Kipkoech has provided the following additional information:

1. During the year he sold all his poultry on changing over to pig-farming.
2. He disposed of all his standing timber during the year.
3. Farm produce consumed by his family amounted to sh.110,000 during the year.
4. He received a salary from the local co-operative society for work as a management chairman, amounting to Sh.15,000 per month.

5. His wife works in the farm as a manager. She is paid Sh.12,000 per month. The family lives in the farmhouse.
6. The record of fixed assets is as follows:

	Original cost	Year of purchase
Farmworks	**Sh.**	
Farmhouse	2,000,000	1988
Dairy building	400,000	1999
Fences, dips and dams	800,000	1998
Planted wind breaks	120,000	2000
Labour quarters	360,000	1998
Machinery		
Tractor	850,000	1999
10 ton lorry	2,500,000	1999
Dairy machinery	960,000	2000
Others		
Standing timber	800,000	1995
Farm land	7,200,000	1995

Required:

(a) The adjusted taxable farming income for Mr. Kipkoech. (18 marks)

(b) Mr. Kipkoech's tax liability for the year 2005. (2 marks)

(Total: 20 marks)

QUESTION THREE

Mr. Lewis Duncan is a director of Lewin Ltd., a manufacturing company in which he owns 20% of the issued and fully paid up capital. He earns a fixed salary of Sh.1,500,000 per month. For the year commencing 1 January 2006, the board of directors evaluated him and considered various additional means of remunerating him given his excellent performance. The chairman of the board has written to you seek your opinion on the proposals before any of them can be adopted.

1. Giving him a housing loan of Sh.1,000,000 at an interest rate of 5% per annum repayable over a ten year period. Interest for the year will be computed on the loan balance due on 31 December each year. Mr. Duncan would be required to occupy his own house from the date of receiving the loan from the company. He is currently housed by the company.

2. Issuing him 1,000 redeemable preference shares of sh.10 par value for free in recognition of his dedicated and loyal service to the company. The market price of these shares is currently estimated at sh.50 each.

3. Providing him with a fully maintained company car of 2000 cc which was bought in the year 2000 for Sh.600,000 instead of the current mileage allowance of Sh.6,000 per month.

4. Increasing the company's contribution to the unregistered Executive Provident Fund from 5% to 10% of his basic salary per annum.

5. Paying his medical bills and those of his family directly to the doctor instead of the current system where he has to pay the doctor and then claim a reimbursement from the company. He is also entitled to claim a maximum of Sh.30,000 per annum. His normal medical bills are approximately Sh.40,000 per annum. The company has a medical scheme for directors and executive staff.

Required:

(a) Discuss the above proposals with regard to their income tax implications. (18 marks)

(b) Advise the board on the best alternative to ensure Mr. Lewis Duncan stays motivated to work.

(2 marks)

QUESTION FOUR

Omondi, Onyango and Kimani are partners operating a wholesale shop in Kisumu. They share profits and losses in the ratio 2:2:1 respectively. During the year ended 31 December 2005, the partners reported a loss of Sh.10,325,000 after deducting the following:

		Sh.
Interest on capital:	Omondi	406,000
	Onyango	406,000
	Kimani	609,000
Motor vehicle running expenses		532,000
Office expenses		420,000
Goodwill		700,000
Repairs and maintenance		168,000
Loss on investment		55,000
Postage and telephone		297,500
Water and electricity		238,000
Salaries and wages		1,246,000
Donations to charitable institutions		525,000
Subscriptions to KNCCI (Trade		224,000
Association)		605,500
Bad debts expense		280,000
Rent, rates and licences		760,000
Professional fees		960,000
Depreciation		2,329,250
Purchase of lorry		
Salary to partners	Omondi	700,000
	Onyango	735,000
	Kimani	1,008,000

Additional information:

1. Office expenses included cost of office cabinet of Sh.192,500.
2. The partnership received dividends amounting to Sh.462,000 (net) from various stocks held in different companies. This was excluded from the above computation.
3. The partnership received Sh.910,000 being insurance recovery for stocks which were destroyed by fire in 2004. This was omitted in arriving at the reported loss above.
4. Motor vehicle running expenses included Sh.21,000 per month related to personal travel by the partners.
5. Provision for bad and doubtful debts account for the year was as follows:

		Sh.			**Sh.**
Bad debts written off		430,500	General	brought	577,500
Specific	carried	336,000	forward		266,000
forward		682,500	Specific	brought	605,500
General	carried	1,449,000	forward		1,449,000
forward			Profit and loss account		

6. Omondi had taken goods worth Sh.122,500 for his own use. This was not recorded in the books of account.

7. Included in repairs and maintenance is Sh.140,000 paid for office partitions during the year.

8. The partners had other incomes as follows:

	Omondi	Onyango	**Kimani**
	Sh.	**Sh.**	**Sh.**
Rent (net)	200,000	-	350,000
Farming income	-	750,000	(745,000)
Interest (net)	191,250	81,600	-
	391,230	831,600	(495,000)

9. Capital allowances have been agreed with the Commissioner at Sh.906,000.

Required:

(a) The taxable profit/(loss) for the partnership business for the year 2005. (8 marks)

(b) Show the allocation of the profit/(loss) among the partners. (6 marks)

(c) Compute tax payable by each partner. (6 marks)

QUESTION FIVE

(a) Recently, traders opposed a move by Kenya Revenue Authority requiring them to keep stock records on a daily basis arguing that it would result in increased cost of compliance. However, upon review of the VAT Act, one realizes that record keeping in general has all along been part of the VAT regulations.

List down ten examples of records that must be kept for purposes of accounting for VAT. (10 marks)

(b) Under the VAT regulations, taxable value of supplies is the price at which the goods are provided.

Required:

Calculate the value for VAT and the amount of VAT under each of the following circumstances:

(i) Kucheza Limited imported computers valued at Sh.1,500,000. A duty of 20% was charged by the customs department. (2 marks)

(ii) ART (K) Ltd. sold a fridge by hire purchase. The cash price was Sh.96,000 while the hire purchase price was Sh.165,000 with a 20% down payment plus 20 monthly instalments of Sh.6,600. (2 marks)

(iii) The price of a motor car was Sh.2,500,000. A cash discount of 20% was allowed to Peter when he bought the vehicle. (2 marks)

(iv) Ernest and Kamau, a professional accounting firm provided free accountancy and auditing services to the bomb blast project. This project, a charitable undertaking, was initiated to help victims of the 1998 bomb blast. The value of the services provided is estimated at Sh.2,400,000. (2 marks)

(v) ABC Ltd. purchased goods worth Sh.1,200,000 from Colour Packaging Ltd. This excluded cost of packaging and transportation charged by Colour Packaging Ltd. amounting to Sh.96,000. (2 marks)

(Total: 20 marks)

SUGGESTED ANSWERS

QUESTION ONE

(a) (i) Bond security:

- This is where a personal taxpayer delivers a document as prove of legal ownership of an asset and enters into a binding agreement to fulfill his obligations with regard to compliance and payment of tax.

- If the person fails to fulfill the conditions he loses the asset.

(ii) Single business permit:

- This is a license granted by local authorities to businesses operating within their jurisdiction.

- It replaces the local authority service charge and other licenses that were issued by different Government departments.

(iii) <u>Customs bonded warehouse:</u>

This is a place/store licensed by the commissioner for customs and excise for deposit of dutiable goods for which duty has not yet been paid. It helps in reducing clogging of goods at the port and also facilitates smooth handling of transit goods.

(iv) Stamp duty:

- This is chargeable in respect of certain legal documents such as partnership deeds, hire purchase agreements, lease agreements, mortgages, etc. as specified in the Stamp Duties Act (Cap.480). Any legal instruments which have not been duly stamped are inadmissible as evidence in any civil proceedings and may not be registered or legally enforced as evidence of ownership.

- Duty is payable within 30 days of the execution of the instrument.

(b) (i) Ukulima Sacco

Taxable Income for the year 2005

	Sh.
Rental Income (70% of 2,252,500)	1,576,750
Dividend Income (85% of 424,000)	360,400

Interest Income (85% of 747,300)	635,205
Taxable income	2,572,355

Tax payable

30% of 2,572,355 = Sh. 771,706.50

(ii) Information not used

Interest from loans to members – This is not taxable

Expenses – These are ignored since income is assessed gross.

QUESTION TWO

(a) MR. KIPKOECH
COMPUTATION OF TAXABLE INCOME 2000

	Sh.	**Sh.**
Net profit as per accounts		1,680,000
Add back:		
Wages of house girl		
Subscriptions to U.G.S.C	60,000	
Depreciation:	60,000	
Dairy machine	120,000	
Tractors and lories	420,000	
Salary to wife	144,000	
School fees for son	120,000	
Life insurance – self	40,000	
Hail damage to pyrethrum	240,000	1,314,000
Produce consumed by family	110,000	2,994,000
Less:		
Farm work deductions (W-1)	742,222	
Wear and tear (W 2)	905,156	
Interest from co-operative bank	80,000	
Dividends from co-operative society	175,000	
Taxable farming income		(1,902,378)
		1,091,622

Workings

W1 Farm work deductions

	Sh.
Farm house (⅓ of 2M)	666,667
Dairy building	400,000
Fences, dips and dams	800,000
Labour quarters	360,000
	2,226,667

Farm work deductions: ⅓ of 2,226,667 = 742,222

W2 Wear and Tear

Class	**Sh.** **I @ 37.5%**	**Sh.** **IV @ 12.5%**	
Tractor	850,000		
Lorry	2,500,000		
	3,350,000		
Wear and Tear 2004	1,256,250		
WDV 31/12/2004	2,093,750		
Additions			
Dairy machines	-	960,000	
	2,093,750	960,000	
Wear and Tear: 2005	(785,156)	(120,000)	905,156
WDV 31/12/2005	1,308,594	840,000	

(b) Mr. Kipkoech's Tax Liability

Farming income	1,091,622
Employment	180,000
Dividend	205,882
	1,477,504
Sh.121,968 @ 10%	12,196.8
Sh.114,912 @ (15% + 20% + 25%)	68,947.2
	303,240.0

Sh.(1,477,504 – 466,704) @ 30%	(13,944.0)
Less Personal relief	
W/T on non-qualifying dividend	(30,882.0)
= 15% x 205,882	339,558.0
Net tax liability	

QUESTION THREE

(a) (i) House loan:

- The loan would be subject to fringe benefit tax which is payable by the employer at the corporate rate of tax. 1,000,000 x (15%, - 5%) x 30% = 30,000
- It is computed on the difference between the interest rate charged and the market interest rate.
- For Duncan the loan is not taxable on him.
- Mr. Duncan will also benefit by the savings he will make on the housing benefit which he is currently paying tax on. The benefit is material because it is based on his global income.

(ii) Share issue:

- There will be no tax benefit for Mr. Duncan since he will be taxed on the value of shares when ownership passes. Benefit 1000 x 50 = 50,000
- In the long run he will be entitled to dividends for which WHT will be deducted @ 5% and is final tax.
- On the employer there are no tax implications.

(iii) Company car:

- There will be no advantage for Duncan since his tax liability will increase if he is given a company car. Currently he is being taxed on the Sh.6,000 mileage allowance. However, if given the car this taxable benefit will double to Sh.12,000 per month.

- On the company there are no major tax implications. However, the company can claim wear and tear allowance on the vehicle and repair and maintenance of the car.

(iv) Increase pension contributions:

- Since the provident fund is not registered there will be no immediate benefit for Mr. Duncan. However, in the long term his savings into the pension scheme will double and increase his tax liability.

- On the company the amount will not be allowable for tax purposes.

(v) Medical bills:

- Whichever way this does not change Mr. Duncan's taxable income, unless the company intends to pay the full bill for Duncan which means he benefits by a furthur Sh.10,000 tax free.

- On the company given that the scheme is for senior employees only the amounts paid are not allowable for tax purposes.

(b) Preferred alternative:

- From the above it appears that giving Mr. Duncan a loan of Sh.1,000,000 to purchase a house is the most beneficial taxwise. This is because he will not only get an additional tax-free benefit but also reduce his taxes as a result of discontinuing the house benefit.

- However on the part of the company providing a house loan will result into higher taxes as a result of the fringe benefits tax.

QUESTION FOUR

(a) OMONDI, ONYANG AND KIMANI
COMPUTATION OF TAXABLE PROFITS

	Sh.	Sh.
Accounting loss		(10,325,000)
Add back		
Interest on capital		
Insurance recovery	910,000	
Omondi	406,000	
Onyango	406,000	
Kimani	609,000	
Office expenses – cabinet	192,500	
Goodwill	700,000	
Salary to partners:		
Omondi	700,000	

Onyango	735,000	
Kimani	1,008,000	
Motor vehicle expenses	252,000	
Office partitions	140,000	
Omondi – Goods for own use	122,500	
Depreciation	960,000	
Purchase of lorry	2,329,250	
Donations	525,000	
Increase in general profit	105,000	
Loss on investment	55,000	10,155,250
		(169,750)
Less:		
Capital deductions		906,000
Taxable loss		(1,075,750)
Add:		
Insurance recovery		910,000
Loss		(1,075,750)

(b) Allocation among partners:

	Omondi Sh.	Onyango Sh.	Kimani Sh.	Total Sh.
Interest on capital	406,000	406,000	609,000	1,421,000
Salaries	700,000	735,000	1,008,000	2,443,000
Share of loss	(1,975,900)	(1,975,900)	(987,950)	(4,939,750)
Taxable profit/loss	(869,900)	(834,900)	629,050	1,075,750

(c) Tax payable by each partner:

	Omondi Sh.	Onyango Sh.	Kimani Sh.
Partnership income	(loss)	(loss)	629,050
Rental Income	200,000	-	350,000
Farming income	-	750,000	
Taxable income	200,000	750,000	-
			979,050

Omondi on Ksh.200,000

1st Ksh.121,968 @ 10%	12,196.8
Next (200,000 – 121,968) @ 15%	11,704.8
	23,901.6
Less personal relief	(13,944.0)
Net liability	9,957.6

Onyango on Ksh.750,000

KSh.121,968 @ 10%	12,196.8
Ksh.114,912 @ (15% + 20% + 25%)	68,947.2
Ksh.(750,000 – 466,704) @ 30%	84,989.0
	166,133.0
Less personal relief	(13,944.0)
Net tax liability	152,189.0

Kimani on Ksh.979,050

Ksh. (121,968 @ 10%) + (Sh.114,912 @ (15% + 20% + 25%)]	81,144
	153,704
(Sh.979,050 – 466,704) @ 30%	234,848

	(13,944.0)
Less personal relief	220,904.0
Net tax liability	

QUESTION FIVE

(a) Ten VAT records:

- Copies of all VAT invoices issued in serial number order
- Copies of all debit and credit notes issued in chronological order.
- All purchase invoices, copies of customs entries, receipts for payment of duty or tax.
- Details of goods manufactured and delivered from the factory
- Orders and delivery notes
- Copies of customer entries.
- Annual accounts e.g. P & L a/c
- Purchase and sales books
- Bank statements and pay-in-slips
- Import and export documents
- Cash books, petty cash vouchers and other books of accounts
- Relevant business correspondence
- Records in the computers
- Totals of output and input tax in each period.

(b) (i) **Input Tax:**

		Cost	**VAT (16%)**
1.3	Cameras	500,000	68,966
4.3	Bulbs	200,000	27,586
4.3	Slide Projectors	1,000,000	137,931
6.3	W. Watches	300,000	41,379
12.3	S. Watches	50,000	6,897
15.3	Alarm clocks	80,000	11,035
			293,794

Output Tax:

		Cost	**VAT (16%)**
5.3	Cameras	312,500	43,103

8.3	Projectors	500,000	68,966
9.3	Bulbs	150,000	20,690
18.3	Cameras	312,500	43,103
20.3	Projectors	750,000	103,448
22.3	W. watches	200,000	27,586
25.3	Alarm clocks	72,800	10,041
27.3	S. Watches	75,000	10,345
			327,282

(ii) **VAT Account**

	Sh.		**Sh.**
Bank	293,794	Bank	327,282
Balance c/d	33,488		-
	327,282		327,282
VAT payable is Sh.	33,488		

(iii) Tax is due by 20 April 2002

Penalty for non-payment: Sh.10,000 plus 2% per month.
Interest compounded on tax outstanding.