TAXATION – BLOCK REVISION MOCK 20

QUESTION ONE

(a) Briefly explain the responsibility of partners with respect to:

(i) Filing of the partnership tax returns. (2 marks)
(ii) Penalties for late payment of tax (2 marks)

(b) Mwanzo, Bidii and Faulu have been partners in a firm dealing with the importation and sale of second hand clothes. They shared profits and losses is the ratio of 3:2:1 respectively upto 30 September 2005, when the firm was dissolved. During the nine months to 30 September 2005, the firm presented the following income statement:

Mwanzo, Bidii and Faulu Partnership
Income Statement for the nine months ended 30 September 2005

	Sh. '000'	**Sh. '000'**
Gross profit		18,000
Deduct:		
Rent and rates	1,600	
Salaries: Staff	780	
Mwanzo	1,500	
Bidii	1,200	
Faulu	900	
Depreciation	400	
Balancing deduction	100	
Advertising (neon sign)	250	
Interest on capital:		
Mwanzo	600	
Bidii	400	
Faulu	200	
Commission paid to Faulu	80	
Water and electricity	300	
Insurance	190	(8,500)
Net profit		9,500

On 1 October 2005, Bidii was employed as a sales manager by Mavazi Limited. The terms of his employment provided for the following:

1. An annual salary of Sh. 960,000 (PAYE Sh. 144,000 per annum).

2. His monthly allowances were specified as follows:

		Sh.
Entertainment		18,000
Travelling	(on	24,000
business)		30,000
House		

3. A medical scheme exists for senior managers only. It is operated on a reimbursement basis. In the three months ended 31 December 2005, Bidii claimed Sh. 120,000 for medical expenses paid.
4. He was entitled to a Christmas bonus of 5% of his annual salary, paid pro rata to months of service.
5. He contributed 10% of his monthly basic salary to a registered provident fund.

Required:

(i) Compute the taxable profit or loss of the partnership for the period ended 30 September 2005. (6 marks)

(ii) Allocate this profit or loss among the partners. (2 marks)

(iii) Determine Bidii's taxable income for the year ended 31 December 2005 and his tax liability. (8 marks)

(Total: 20 marks)

QUESTION TWO

(a) The Minister for Finance, through the budget speech of June 2004, issued an amnesty to tax defaulters in Kenya. This amnesty expires on 31 December 2004.

Required:

(i) Define the term 'tax amnesty.' (2 marks)

(ii) Explain two advantages of a tax amnesty from the viewpoints of:

- The Kenya Revenue Authority (4 marks)
- The tax payer (4 marks)

(b) Highlight three key features of each of the following taxes;

(i) Motor vehicle advance tax (3 marks)

(ii) Fringe benefit tax (3 marks)

(c) With reference to the Customs and Excise Act (Cap. 472), outline four circumstances under which the Commissioner may grant a refund for import duty paid. (4 marks)

(Total: 20 marks)

QUESTION THREE

(a) With reference to the VAT Act (Cap. 476), define the following terms:

(i) Time of supply (2 marks)
(ii) Minimum turnover (2 marks)
(iii) Tax invoice (2 marks)
(iv) VAT tribunal (2 marks)

(b) Kikomatt Supermarket Limited registered for VAT on 15 December 2005. On that date, it had goods in stock for sale valued at Sh. 96,000 and for which input tax had been paid. These goods were subsequently sold in March 2006.

During the four months ended 30 April 2006, the supermarket completed the following transactions:

Month	**Purchases**	**Sales**
	Sh.	**Sh.**
January	2,450,000	3,200,000
February	2,870,000	3,460,000
March	3,250,000	2,940,000
April	3,120,000	3,500,000

The purchases and sales are inclusive of VAT, at the standard rate, where applicable.

Additional information:

1. 10% of the monthly purchases and sales relate to exempt goods.
2. 20% of the monthly sales represent goods exported to Uganda.
3. Credit notes amounting to Sh. 25,000 were issued to customers in March 2006.
4. VAT on monthly electricity consumption was Sh. 2,000.

Required:
The VAT account for the four month period ended 30 April 2006.
(12 marks)

(Total: 20 marks)

QUESTION FOUR

Chai Limited was incorporated on 31 December 2004 to process and package tea for sale within Kenya. On 2 January 2005, the company purchased the following movable assets and buildings from Mwisho Limited, an existing company in the same business.

Asset	**Tax written down value Sh. '000'**	**Selling price to Chai Limited Sh. '000'**
Machinery	18,000	10,000
Standby generator	200	250
Computers	750	400
Printers	90	110
Loose tools (original cost Sh.	100	70
150,000)	7,200	8,000
Delivery vans (3 tonnes each)	150	80
Mobile phones	1,400	1,000
Office furniture	30	28
Weighing scales		

Nature of building	**Construction date**	**Construction cost Sh. '000'**	**Selling price to Chai Limited Sh. '000'**
Factory	1 January 1998	40,000	48,000
Office complex	1 January 1998	22,000	26,000
Warehouse A	1 July 1999	2,000	1,800
Warehouse B	1 January 2000	1,700	2,400
Staff quarters	1 August 2001	3,600	4,000
Staff Canteen	1 December 2001	900	750

The following additional transactions occurred in the year ended 31 December 2005:

1. On 1 March, one of the delivery vans purchased from Mwisho Limited for Sh. 1.2 million was sold for Sh. 700,000.

2. As the number of employees increased. Warehouse B was converted into an office with effect from 1 April. The cost of partitioning the warehouse amounted to Sh. 150,000.
3. Additional staff quarters were constructed at a cost of Sh. 800,000 and utilized from 1 July.
4. On 1 October, a machine was imported at a cost of Sh. 450,000 and the following costs subsequently incurred on it:

	Sh.
Import duty	100,000
Carriage inwards	40,000
Repairs in transit	18,000
Installation costs	5,600
Annual insurance	12,000

5. One of the computers valued at Sh. 18,000 was traded in on 2 November for a new one costing Sh. 50,000. The balance was settled in cash.
6. The company reported a profit before capital allowances of Sh. 26 million for the year ended 31 December 2005. This was after deducting depreciation of Sh. 2 million.

Required:

(a) Determine the capital allowances due to Chai Limited for the year ended 31 December 2005.

(16 marks)

(b) Compute the company's taxable profit or loss and the tax payable (if any) for the year ended 31 December 2005.
(4 marks)

(Total: 20 marks)

QUESTION FIVE

(a) Mr. Allan Muvozi is a Ugandan businessman wishing to invest in Kenya. He has approached you for professional advice on the tax implications of various forms of business.

Required:

Explain to him four tax advantages enjoyed by a sole proprietorship over a company. (8 marks)

(b) Mr. John Mpole accepted voluntary retirement from the Civil Service on 1 January 2006. He received a golden handshake of Sh. 2 million. He is now considering six possible investments as listed below:

1. Purchase ordinary shares in Kenya Airways Limited.
2. Purchase ordinary shares in Uganda Breweries Limited.
3. Open a fixed deposit account with Kenya Commercial Bank Limited.
4. Purchase government Treasury bills.
5. Open a savings account with Kenya Post Office Savings Bank Limited.
6. Subscribe for debentures in National Bank of Tanzania Limited.

Required:

For each of the investments above, advise Mr. Mpole on the income tax consequences. (6 marks)

(c) List and briefly explain three ways in which a government can reduce its budget deficit. (6 marks)

(Total: 20 marks)

SUGGESTED ANSWERS

QUESTION ONE

(a) (i) The partners have the responsibility of filing the partnership business returns by the end of the 4th month after the end of the calendar year i.e. 30th April. The returns will form the basis of determining how profit was shared and the taxable income from partnership business

(ii) Late payment of tax will attract the following penalties

- Late payment penalty of 20% of unpaid tax
- 2% p.m interest penalty on unpaid tax plus penalty

(b) (i) Adjusted partnership income for a months net profits

Net profits	9,500,000
Add back	
Partners salaried 1500 + 1200	3,600,000
+ 900	400,000
Depreciation	250,000
Advertising - -neon sign	1,200,000
Interest on capital 600 + 400	80,000
+ 200	15,030,000
Commission to Faulu	
Adjusted partnership income	

(ii) Allocation of profits

Sh '000'

Partner	M	B	F	Total
Salary	1,500	1,200	900	3,600
Interest	600	400	200	1,200
Commissions	-	-	80	80
Profit share	5,075	3,383.3	1,691.7	10,150
3:2:1	7,175	4,983.3	2,871.7	15,030

(iii) Bidii's income

Employment income – 3 months		**Ksh**
Salary 960 000		
Allowances-entertainment 18 000 x		240,000
3/12		54,000
House 30 000 x		90,000
3		120,000
Medical (discriminating)		12,000
Bonus 5% x 240 000		516,000
Pensionable pay		
Less contributions to registered fund	154,800	
Lower of (1) 30% x 516,000 =	52,500	
(2) Set limit = 210 000	24,000	(24,000)
x3/12 =		492,000
(3) Actual amount = 10% x		4,983,000
240 000		5,475,000
Income from employment		
Income from P/ship business		12,196.8
Total taxable income		68,947.2
Total liability		1,502,489.0
1st Ksh. 121,968 @ 10%		1,583,633.0
Next Ksh. 114,912 @ (15% + 20%		(13,944.0)
+ 25%)		(36,000.0)
Surplus Ksh. (5,475,000 – 466,704)		1,533,689.0
@ 30%		
Gross tax liability		
Less personal relief		
PAYE 144,000 x 3/12		
Net tax liability		

QUESTION TWO

(a) (i) Tax amnesty - "forgiveness" of tax liability and or penalties associated with past tax that was evaded. The tax amnesty with 31st Dec 2004 was on interest, fines and penalties on tax evaded in the past. The taxpayer has to disclose and pay such evaded tax only

- The amnesty was in respect of fines, interest and penalties associated with the following types of taxes evaded

  - Income tax for year 2003 and prior years

- Customs duty on imported goods before 11/6/2004
- Excise duty on goods manufactured and/or sold before 30/4/2004
- A VAT on goods and services supplied before 11/6/2004

(ii) Advantages of tax amnesty to

(a) KRA

- Increased tax revenue to government
- Higher level of compliance in future
- More people are brought into the tax net

(b) Tax payer

- No prosecution or indepth investigation for past tax evasion
- No payment of penalties, interest and fines
- Higher tax compliance in future

(b) Features of

(i) Motor vehicle advance tax (section 12 A of Cap 470)

- Paid by owners of commercial vehicles and public service vehicles P.S.V
- Paid in advance at the beginning of the year
- Based on number of passengers or weight of luggage
- Can be offset against tax liability of the business

(ii) Fringe benefit tax (FBT)

- Payable together with P.A.Y.E on monthly basis
- Based on corporate tax rate of 30%
- Based on fringe benefit resulting from granting of low interest rate loan to the employee by employer below market interest

$$FBT = \left(\begin{matrix}\text{Market interest} - \text{Low interest} \\ \text{rate} \qquad\qquad\qquad \text{rate}\end{matrix}\right)\text{Amount of loan x 30\%}$$

- Paid by the employer will effect from 11th June 1998

(c) Refund of import duty paid

- Where goods are returned to seller
- Where duty was paid in error i.e. over paid
- Where goods are lost or destroyed while under customs control
- Where goods are used in production of exports members of diplomatic missions, Armed forces, NGO's etc

QUESTION THREE

(a) (i) The time for supply for VAT purposes shall be earliest of the time when

- goods are supplied or services rendered or
- an invoice is issued in respect of the supply or
- payment is received for all or part of the supply or
- certificate is issued by an architect, surveyor or any person acting in a supervisory capacity in respect of the service

(ii) Minimum Turnover

Compulsory registration for VAT applies to any person who in the course of business supplied or expect to supply taxable goods or services or both, the values of which in any of the following periods exceeds the value shown

12 months	Ksh. 3,000,000
9 months	Ksh. 2,400,000
6 months	Ksh. 1,800,000
3 months	Ksh. 1,200,000

(iii) Tax invoice

- A registered person who makes taxable supply shall issue a tax invoice at the time of supply or within 14 days of the completion of that supply.

- For cash sale, a tax invoice must be issued immediately

- A simplified tax invoice should show the following

    - Date of invoice
    - Brief description of supply made

- Name address, PIN and VAT registration number of the supplier
- Serial number of the invoice
- Total amount charged inclusive of VAT
- Explicit statement that the price is inclusive of VAT

IV VAT Tribunal

- Established by minister of Finance to arbitrate tax disputes between commissioner of VAT and person registered for VAT
- Consists of chairman and two other members of the general public
- The minister prescribes the manner in which an appeal is made to the tribunal. The tribunal can confirm, reduce, nullify or increase the tax assessed
- A tax payer aggrieved by the decision of the Tribunal can appeal to the high court

4 Months VAT A/C

Input VAT		Output VAT	
VAT bills 2,000 x 4	8,000	January	
January		Exports 3,200,000 x 20% x 0%	0
90% x 2,450,000 x $\frac{16}{116}$	304,138	Std sales 3,200,000 x 70% x $\frac{16}{116}$	308,965
February		February	
90% x 2,870,000 x $\frac{16}{116}$	356,276	Exports 3,460,000 x 20% x 0%	0
March		Std sales 3,460,000 x 70% x $\frac{16}{116}$	334,009
90% x 3,250,000 x $\frac{16}{116}$	403,448	March	
April		Exports 2,940,000 x 20% x 0%	0
90% x 3,120,000 x $\frac{16}{116}$	387,310	Std sales 2,940,000 x 70% x $\frac{16}{116}$	283,862

Return inwards $\frac{16}{116}$ x 25,000 3,448

April	
Exports 3,500,000 x 20% x 0%	0
Std sales 3,500,000 x 70% x $\frac{16}{116}$	337,931
VAT refund	197,793
	1,462,620

QUESTION FOUR

(a) For the purpose of computing capital allowances on purchased item Chai Ltd will

(i) Inherit residual/ WDV of the Buildings and loose tools

(ii) Use the Buying price for the rest of the assets

CAPITAL ALLOWANCES

(i) Diminution in value of loose tools @ 331/3% p.a

Year	**Diminution**
2004	150,000 x 1/3 = 5,000 (enjoyed by Mwisho Ltd)
2005	150,000 x 1/3 = 50,000
2006	150,000 x 1/3 = 50,000

(ii) Investment deduction
Qualifying cost of machine = 450,000 + 100,000 + 40,000 + 18,000 + 5,600 = 613,600

Asset	Q.Cost	I.D@ 100%	residual
Machinery	613,600	613,600	---
		613,600	

The factory building is assumed to have enjoyed 100% I.D in 1996

(iii) Industrial building deduction IBD
Residual as at 2/1/2005

Building	Cost	Years	in	IBD@	Residual

		existence	2.5%	
Warehouse A	2,000,000	5.5 yrs	275,000	1,725,000
Warehouse B	1,700,000	5.5 yrs	212,500	1,487,500
Staff quarters	3,600,000	3.41667 yrs	307,500	3,292,500
Staff canteen	900,000	3.08333 yrs	69,375	830,625

YEAR 2005 IBD

Building	Q Cost	Residual b/f	IBD@ 2.5%	Residual c/f
Warehouse A	2,000,000	1,725,000	50,000	1,675,000
Warehouse B	1,700,000	1,487,500	10,625	-
Old Staff quarters	3,600,000	3,292,500	90,000	3,202,500
Staff canteen	900,000	83,625	22,500	808,125
New Staff quarters	800,000	-	10,000	790,000
Total IBD			183,125	

Warehouse B was used for only 3 months hence IBD

= 1,700,000 x 2.5% x 3/12 = 10,625

New staff quarters were utilized for 6 months hence IBD

= 800,000 x 2.5% x 6/12 = 10,000

Office Building dies not qualify for IBD

(iv) Wear and Tear allowance (WTA) Sh '000'

Class	I @ 37.5%	II @ 30%	IV @ 12.5%
Machinery + generator	-	-	10,250
Computers + printers +	-	590	-
mobiles	8,000	-	-
Delivery vans	-	-	1,028
Furniture + weighing scale	-	-	150
Add: partitions –	-	50	-
warehouse B	(700)	-	-
Computers	-	(18)	-
Less: delivery van	7,300	622	11,428
Computer	(2,737.5	(186.6)	(1,428.5

	4,562.5	435.4	9,999.5
WTA			
WDV			
Total WTA = 4,352,600			

(b)

Profits		26,000,000
Add back depreciation		2,000,000
		28,000,000
Less capital allowances		
Diminution	50,000	
Investment deduction	613,600	
I.B.D	183,125	
W.T.A	4,352,600	(5,199,325)
Adjusted taxable profits		22,800,675
Tax liability = 30% x 22 800 675		6,840,202.5

QUESTION FIVE

(a) Four tax advantages enjoyed by a sole proprietorship over a company

- Income taxed on individual and not business

- Income taxed on graduated scale such that the lower the income, the lower the tax unlike a constant corporate tax rate for a company.

- The individual shall be granted a personal and insurance relief (if he takes a life or education policy) which are not available to a company

- The withholding tax on incomes such as qualifying dividends and interest are final for individuals.

(b) (1) Purchase ordinary shares in Kenya Airways Ltd

- The dividends received will suffer a 5% final withholding tax while any capital gains realised on disposal of shares is tax exempt

(2) Purchase ordinary shares in Uganda Breweries Ltd

- The dividend income receivable or even capital gains realizable are tax exempt since they are derived from outside Kenya

(3) Open a fixed deposit Account with KCB Ltd.

- The interest income is subject to a 15% final withholding tax

(4) Purchase Government Treasury bills

- These are considered as riskless investments but the interest income is subject to a 15% final withholding tax

(5) Savings account with POSB Ltd

- The interest income earned on deposit with post office savings bank is <u>tax exempt</u> according to the first schedule of cap 470 (income tax Act)

(6) Subscribe for debentures in national Bank of Tanzania Ltd

- Interest income is tax exempt in Kenya since it is derived from outside Kenya

(c) The government can reduce its budget deficit by

(1) Internal borrowing through the issue of Treasury bills and bonds

(2) External borrowing from IMF and world bank

(3) Enhance tax revenue collection through administrative efficiency and bringing more people into the tax net

(4) Sale of national assets e.g. privatization of parastatals to eliminate their financing thus reducing government expenditure.