TECHNICAL UNIVERSITY OF MOMBASA

DEPARTMENT OF ACCOUNTING AND FINANCE

DIPLOMA IN ACCOUNTING

BAC 2208: TAXATION 1(SUPPLEMENTARY)

SERIES:MAY 2016

2 HRS

INSTRUCTIONS: ANSWER QUESTION ONE AND ANY OTHER TWO QUSTIONS

QUESTION ONE

a) i) Define the term 'tax planning'

(2 marks)

ii) Briefly explain two instances in which a business may apply the concept of tax planning

(4 marks)

(b) The Kenya Revenue Authority (KRA) is geared towards a function-based organization rather than one structured along the types of taxes. This is evidenced by the integration of VAT, Income Tax and Excise departments into the Domestic Department.

Asses the likely benefits and drawbacks to KRA arising from this integration.

(4 marks).

c) Highlight the benefits of an effective tax policy to a developing country.

(4 marks)

d) With reference to section 132(7) of the Income Tax Act (Cap.470), list six types of transactions for which personal identification number (PIN) is required.

(6 marks)

QUESTION TWO

Write brief notes on the following

(a) Withholding VAT agents (4 marks)

b) Compensating tax (4 marks)

(c) Bond security (4 marks)

(d) Fringe benefit tax (4 marks)

(e) Exempt interest income (4 marks)

(**Total: 20 marks)**

QUESTION THREE

a) Write brief notes on the following:

i) Tax-free employment benefits

(6 marks)

ii) Set off of import duty (4 marks)

b) Local supplies of goods and services to an Export Processing Zone (EPZ) are zero rated under the VAT Act (Cap 476)

Explain the two alternative methods of zero rating such supplies.

(6 marks)

c) With reference to the Income Tax Act (Cap.470) explain how a Kenyan branch of a foreign company is taxed

(4 marks)

QUESTION FOUR

Section 24 (1) of the Income Tax Act (Cap 470) requires companies to adequately distribute their profits as divided within twelve months after the end of the accounting period.

Outline the circumstances under which a company may apply for exemption from the shortfall distribution requirements.

(4 marks)

b) The following information relates to Vuma Limited for the year ended 31 December 2004:

The company's operating profit before tax amounted to Ksh.2,000,000 excluding Ksh.400,000 from investment activities

The company intends to distribute Ksh.200,000 as dividend for the year ended 31 December 2004.

The corporate tax rate is 30%

Required:

Compute the short fall tax payable by Vuma Limited for the year ended 31 December 2004.

(4 marks)

c) Write short notes on the following:

i) Exemption of individuals from paying instalment tax

(4 marks)

ii) Double taxation relief

(4 marks)

iii) Refund of overpaid tax

(4marks)

(Total: 20 marks)

QUESITON FIVE

Explain briefly the key provision of Section 125 of the Income Tax Act (Cap. 470) relating to the official secrecy binding all employees of the Income Tax Department. (4 marks)

(b) Explain the term “thin capitalization.” (4 marks)

(c) Name four incentives given by the government to encourage the growth of capital market in Kenya.

(4 marks)

(d) Explain briefly the meaning of “goods subject to customs control” under the Customs and Excise Act (Cap. 472) 4 marks)

(e) Explain the requirements of an application for refund of VAT paid in respect of Bad debts. (4 marks)

(Total: 20 marks)

QUESTION ONE

a) i) Tax planning

- Ø The arrangement of affairs of tax payer in such a way as to minimize tax liability at the lowest cost without contradicting any tax laws and regulations. It involves determining in advance the tax effect of any proposed business action and decision.
- Ø It requires a deep understanding of tax legislations and decided case law of taxation. The aims of tax planning are to

i. Achieve the most advantageous financial position from business transactions measured in terms of direct tax savings and improved cash inflows.

ii. Ease tax administration (internally) in terms of methods of accounting for tax, records to be maintained and tax reports to be prepared.

iii. Achieve the highest level of compliance with the tax laws.

ii) The planning areas in business decision may include

- Ø Lease a buy decisions – do we lease assets and pay lease charges (allowable) or buy assets and enjoy capital allowances
- Ø Financing decisions: - do we use debt capital (interest charges are allowable) or equity capital (dividends not allowable)
- Ø Firm of business ownership – do we operate as a partnership, sole proprietorship or a limited company.

- Ø Trading decisions – do we produce and sell locally or export (exports are zero rated for VAT purposes)

(a) Benefits as a result of integration of the Departments into Domestic Taxes Departments

- The integration has eliminated duplicated of functions, leading to resource savings that can be applied to other critical areas such as automation.
- It has led to enhanced taxpayer compliance and risk assessment given that taxpayers are monitored for all taxes and there is more sharing of information.
- There is better relationship with the clients as they are no longer subjected to separate audits from income Tax and Vat officers. This is due to better co-ordinated approach to tax audits and taxpayers education.
- The management is able to monitor the effectiveness of tax audit and other programmes in totality as opposed to the previous situation where one programme was being performed across different departments.
- Integration has reduced the likely incidence of corruption as a taxpayer is now likely to be audited by a team, not an individual officer from a department.
- Information sharing is possible.

(10 marks)

Drawbacks from integration.

- Lack of clear responsibilities

i. Previously, it was possible to place responsibilities for attaining targets on various commissioners be it for customs and excise VAT, Income Tax etc. Variations were easier to spot. Not possible now since all these are integrated into one.

ii. Tax payers do not clearly know who to report to at KRA i.e. whether they fall under Large Taxpayer Unit or otherwise. No clear guidelines.

(10 marks)

(b) Benefits of effective tax policy to a developing country.

- Increased rate of savings and capital accumulation.
- Mobilising of economic surpluses i.e. excess of current output over essential consumption for accelerating economic growth.
- Indirect taxes are utilised to:

  -Promote development by checking conspicuous consumption.

  - Mobilise resources for the public sector

  - Increase the savings ratio

· A suitable tax policy directs resources from:

- Private to public sector

- Consumption goods industries to investment goods industries.

- Import goods to export goods.

a) Transaction of for which PIN is required.

The 13th Schedule of Income Tax Act indicates the following transactions with various institutions

- Registration of titles and stamping of transactions by commissioner of lands
- Registration of motor vehicles transfer by registrar of motor vehicles.
- Underwriting of policies by insurance companies
- Trade licensing by Ministry of Commerce
- Application for VAT registration
- New registration of business and companies
- Importation and exportation of goods, customs clearance and forwarding under customs and excise
- Payment of deposit for power connection by KPLC
- Approval of plans by and payment of water deposits to local authorities

QUESTION TWO

(a) Withholding VAT agents

- VAT is tax paid by end users or consumers.
- The participants in the production and distribution chain are only to collect VAT on behalf of the tax authorities.

- VAT is a multi-stage tax where withholding tax agents collect VAT at each stage.
- The withholding tax agents who account for VAT at each stage include; suppliers, manufactures, wholesalers and retailers
- VAT payable= output tax –input tax withheld at each stage.

Compensating tax

Introduced in 1993

Additional tax affecting companies

Arises when the dividends paid and tax refunds exceed dividends received and tax paid in the year.

i.e. Compensating tax

Dividend paid x + Tax refunds Minus Dividend received x minus taxes paid

Where t = Corporate tax rate

The computation of the compensating tax should be reflected in the self assessment return.

© Bond security

The commissioner may require a person to give security to:

- Ensure due compliance by the person with the provisions of CAP. 472
- Protection of customs and excise revenue on imported goods
- Cover any transaction entered into by the person within a specified period.

(d) Fringe Benefit Tax

- It is tax paid by the employer on fringe benefits granted to the employee.
- Fringe benefits are loans granted by the employer to the employees at an interest rate that is lower than the prescribed interest rate.
- For loans granted after 11th June 1998 employers are required to pay fringe benefit tax at the resident corporate tax rate, on the difference between market interest rate and the rate paid by the employees.
- Prescribed low interest rate for January to June 20006 is 8%.
- Prescribed market interest rate for April to June 2006 is 8%.

(e) Exempt interest income

- Interest received from outside Kenya.
- Interest income of a registered retirement scheme or fund.

- Interest income arising from contribution to home ownership savings plan (Hosp) after ten years of saving.
- Interest arising from government stocks/bonds and Nairobi city council stocks held by non-residents.
- Interest from savings in post office savings bank.

QUESTION THREE

Tax free (exempt) employment benefits

- Fringe benefits
- Benefits in kind not exceeding Ksh.36,000 p.a (3,000p.m)
- Education fees paid by employer for employee and his dependents if such fees are taxed on the employer.
- Medical benefits if scheme is non-discriminative.
- Passages/translocation costs for non-citizen expatriates.
- Contribution by employer for employees to registered and unregistered pension and provident funds.

Import duty is refundable or set off if:

- Imported goods are returned to the seller
- Duty was paid in error (overpaid)
- Where goods are destroyed/ damaged while under customs control ware
- Where goods are destroyed or lost through accident
- Where imports are used in production of exports or other specified duty exempt goods
- Duty was paid by privileged persons as institutions such as WB, UN, Armed forces etc

b) Methods of zero rating supplies to EPZ

1) Supplies of taxable goods and services to EPZ businesses could be made without charging VAT provided that the suppliers maintain records of

- Proof of payment made for on acquisition of such goods and services.
- A certificate signed by the buyer (EPZ business) that the goods were received.
- A copy of the invoice showing the supply of goods or services to the EPZ business.

2) Treating EPZ as a territory outside Kenya.

- Local suppliers to EPZ businesses are treated as exporters and exports are zero rated.
- They charge V.A.T at zero rate (zero output VAT) on such supplies but they have to complete the usual export entry forms and maintain copies thereof duly certified by a proper office of customes at their business premises.
- The copies would be examined by VAT officers during routine audit examination.

c) Taxation of a Kenyan branch of a foreign company (Section 18 of Cap 470)

- The branch is considered as a non-resident and taxed at 37.5% corporate tax rate
- Expenses of interest, royalties and management or professional fees paid to head office are not allowable expenses.

- Sales abroad (exports) by the branch of items manufactured locally are deemed to have arisen in Kenya hence taxable in Kenya
- Expenditure incurred by the branch outside Kenya is only allowable/deductible to the extent the CDT may consider.

QUESTION FOUR

a) Shortfall distribution tax

- A tax imposed on companies which have not met the commissioner's requirements as to distribution of dividends.
- Companies are required to distribute at least 40% of their operating profit after tax and 100% of other incomes.
- A short fall distribution arises if the actual distribution is below the minimum distribution.
- Shortfall tax = 30% (Minimum distribution – Actual distribution)
- Exemptions from shortfall distribution tax
- Where the company is facing liquidity problems.
- Where the company has commitments to purchase fixed assets
- Where the company has commitments to repay loans
- Where shareholders do not owe the company any amounts.

b) Vuma Ltd

Shortfall distribution tax

The investment income is not taxable since it is only available for distribution to shareholders. Its only operating income which is taxable. The mandatory distribution is 40% (60% retention)

Operating income	2,000,000
Less tax @ 30%	600,000
Distributable profits	1,400,000
Less 60% statutory retention	(840,000)
Statutory distribution (40%)	560,000
Add investment income(assumed qualifying)	400,000
Total available for distribution	960,000
Less amount distributed	(200,000)
Short fall distribution	760,000
Short fall distribution tax = 5% x 760,000 =	38,000

c) **Exemption from paying instalment tax**

Non-employment income is less than 1/3 of total income (employment + non-employment)

Tax liability for year of income does not exceed Ksh.40,000.

The source of income is only employment income which is taxed under PAYE

Where total tax liability for the year is expected to be nil or negative (refund)

ii) **Double Taxation relief**

This avoids double taxation of employment income earned by Kenyan citizens from outside Kenya

If a Kenyan citizen earns employment income from Kenya and from foreign country the foreign employment income would be taxed in foreign country and in Kenya. To avoid this double taxation Section 41, 42 and 43 of Cap 470 grants double taxation relief where:

1.The tax payer must prove that the tax was deducted in the foreign country on foreign employment income.

2.The tax payer must claim the double taxation relief within 6 years of paying such tax liability in foreign country.

3.The double taxation relief shall be the lower of

a).Tax paid on foreign employment income in the foreign country

b)Tax paid on foreign employment income in Kenya.

W.e.f. 1/1/2002 a resident person with foreign employment income shall be granted double taxation relief whether or not Kenya has a DTA with the foreign country. Currently, Kenya has a DTA with Zambia, UK, Germany, South Africa, Canada etc.

iii) **Refund of over-paid tax**

- According to Section 105 of Cap 470, refund of overpaid tax shall occur as follows

Where the CIT is satisfied that a person paid, in respect of a year of income tax in excess of amount payable, the CIT shall refund the amount of excess together with any interest

When tax is due and payable by a tax payer who is expecting a refund, any amount refundable shall be applied towards the satisfaction of the tax due and payable

A claim for repayments/refund shall be made within seven years after expiry of the year of income to which the claim relates.

QUESTION FIVE

125.(1) An officer and any other person employed in carrying out the provisions of this Act shall regard and deal with all documents and information relating to the income of a person and all confidential instructions in respect of the administration of the Income Tax Department which may come into his possession or to his knowledge in the course of his duties as secret.

(1A) An officer appointed under section 13 of the Kenya Revenue
Authority Act for purposes of this Act shall, on appointment, make and subscribe
before a magistrate or commissioner for oaths, a declaration in the prescribed
form.

(2) No officer and no other person employed in carrying out the provisions of this Act, shall be required to produce in court a document, or to communicate to a court information, which has come into his possession or to his knowledge in the performance of his duties under this Act except as may be necessary for the purpose of carrying into effect the provisions of this Act or in order to bring or assist in the course of a prosecution for an offence committed in relation to tax.

(3) Nothing in this section shall prevent -

(a) an officer or person from revealing a document or information relating to the income of a person or confidential instructions in respect of the administration of the Income Tax Department to another officer or person so employed in the course of his duties, or to a person authorized in that behalf by the Minister in relation to a person resident in Kenya, or to a court or person for the purposes of this Act;

(b) an officer from revealing a document or information solely for revenue or statistical process to a person in the service of the Government in a revenue or statistical department where that document or information is needed for the purpose of the official duties of that last mentioned person and where last mentioned

person has made a subscribed declaration of secrecy in relation to information coming to his knowledge in the course of his official duties;

(c) an officer from revealing a document or information to the Controller and Auditor General, or to an authorized member of his Department, where that document or information is needed for the performance of his official duties.

(d) An officer from providing to the Board established under the Higher Education Loans Board Act, the name and address of any person granted an education loan or his employer, where such information is required for the performance of the Board's official duties in recovery of the education loans.

(b) "Thin capitalization"

- This refers to the extent of mix of debt and equity capitalized. Debt is defined to include

- Long term loans
- Debentures and bonds
- Short term loans

- Bank overdraft
- Creditors
- Overdrawn current accounts
- Other amounts used t o 3rd parties

(c) Tax incentives given by the government to encourage growth of capital markets

- Withholding tax on dividends is only 5%
- Capital gains are tax exempt
- Floatation costs are tax allowable
- Stock brokerage services are VAT exempt
- Venture capital firms enjoy a 10 year tax holiday
- Income from collective investment schemes is tax exempt

(d) Goods are subject to customs control if measures are taken by commissioner of customs and Excise to ensure compliance with provisions of cap 472. Examples of such goods are

- Goods on which duty (import or excise duty) has not been paid
- Goods subject to seizure
- Restricted exports
- Goods lending exportation stored in a customs area under permission of proper officer
- Goods on board an aircraft to be used or used within Kenya

(e) Refund of VAT for Bad debts

- The refund is made if

- No payment for supplies has been received and 3 yeas have elapsed
- The claim must be made within 5 years of making application

- The following documents must accompany the refund claim application

- Copy of tax invoice issued upon supply
- Declaration that the seller and buyers are independent parties
- Evidence that every effort has been made to recover the amount owed
- Document evidence by liquidator that the