TECHNICAL UNIVERSITY OF MOMBASA

DEPARTMENT OF ACCOUNTING AND FINANCE

DIPLOMA IN ACCOUNTING

BAC 2208: TAXATION

SERIES:MAY 2016

2 HRS

INSTRUCTIONS: ANSWER QUESTION ONE AND ANY OTHER TWO QUSTIONS

QUESTION ONE

a)List and explain any three deductions that may be available against gains or profits from employment. (2 marks)

b) Mr. Hesabu has recently opened an Income Tax Consultancy office in Nairobi. He has been approached by his clients on the following matters.

(i) M/S Watu, Wote, Wao are three partners operating WWW Enterprises. In 2005, they made profits of Sh.180,000. They share profits in the ratio 3:3:4. Wao had overdrawn on his account and was charged Sh.30,000 interest. Watu and Wote received interest of Sh.25,000 each from the partnership. The interest account is included in the above profits. Mr. Wote wishes to know how much tax he would pay. He has no other source of income. (6 marks)

(ii) Live Well Foundation is a Non-Governmental Organisation formed for the purposes of addressing people's spiritual needs. It will derive its income from donations of all kinds, charitable walks and sale of religious literature. They wish to know if they will be required to pay any tax. (4 marks)

(iii) Mrs. Mjini is a happily married housewife residing in Kilimani Estate, Nairobi. Since her compound is big she engages in backyard gardening during her spare time and she derives a lot of satisfaction from it. She also maintains very accurate records of the performance of her garden. Details for the three years ending 31 December 2005 are as follows:

Year ended 31 December 2003 Profit Sh.20,000

Year ended 31 December 2004 Loss Sh.40,000

Year ended 31 December 2005 Profit Sh.50,000

Garden produce consumed by Mrs., Mjini's family during the year of income 2005 was sh.60,000 (not included in the above results). She wishes to know how much tax she should pay from this activity in 2005.

(4 marks)

(iv) New Plastic Limited, manufacturers of plastic products wishes to sponsor research into plants that may produce plastics related materials. They have set aside Sh.20,000,000 which will be awarded to the Department of Biochemistry, Ubora Science University. They wish to know if there is any tax advantage which may arise. (4 marks)

Required:

As Mr. Hesabu's tax manager, write a memorandum on each of the points for his consideration.

(Total: 18 marks)

QUESTION TWO

(a) Specify the rules relating to payment of Income tax under the Pay As You earn rules. (5 marks)

(ii) What are the consequences of failure to deduct and pay tax under PAYE?

(3 marks)

b) You are provided with the following details:

1. Installing a system of ventilation in the factory.
2. Legal expenses incurred when acquiring a new building
3. Giving the factory a fresh cost of plant
4. Replacing 200 tiles on a roof damaged by wind
5. Expenditure incurred in demolishing part of a wall to make room for a recently purchased machine.

Required:

a) From an Income Tax perspective indicate for each of the above items whether it is capital or revenue expenditure.

Explain.

(5 marks)

(b) Explain the role and functions of a Value Added Tax tribunal. (4 marks)

QUESTION THREE

(a) It is common in Kenya to have individuals who cannot distinguish between taxes and charges. Explain the difference between a tax and National social Security Fund deductions. (6 marks)

(b) Specify the basic rules in Income Tax with regards to payment of pension from a registered scheme to:

(i) The pensioner, (3 marks)

(ii) The widow or widower of a pensioner. (4 marks)

(c) Specify the main rules relating to a registered pension fund. (5 marks)

QUESTION FOUR

(a) Name and briefly explain items which may be included in the qualifying expenditure for the purposes of investment deductions. (4 marks)

(b) Write short notes on the following:

(a) Industrial Building – "Hotel" (4 marks)

(b) Exempt Dividend Income. (4 marks)

(c) Non-Resident Individual (4 marks)

(d) Memorandum of Appeal & Statement of Facts. (4 marks)

(Total:20marks)

QUESTION FIVE

Write explanatory notes on the taxes listed below and in each case indicate whether the tax complies with the main principles of a good tax system.

(a) Presumptive tax on agricultural produce. (5 marks)

(b) Cess on agricultural produce. (5 marks)

(c) Trade licence chargeable to professionals. (5 marks)

(d) Stamp duties on transfer of properties. (5 marks)

(Total: 20 marks)

ANSWERS

QUESTION ONE

(a) Deductions that may be available against gains or profits from employment are:

- Mortgage interest (owner occupied interest) paid on loan to buy or improve a residential house up to a maximum Ksh.150,000. Note that where the mortgage interest paid is less than the maximum, the actual interest paid is claimed. Where actual mortgage interest is higher than maximum only maximum allowable can be claimed
- .Actual amount contributed by an employee to a registered pension or provident fund which shall be the lower of (i) Actual contribution or Sh. 240,000 or 30% of pensionable income or set lime of sh240,000
- Contribution to a registered Home Ownership Savings Plan up to Ksh.48,000 p.a., that is Ksh.4,000 p.m.
- N.S.S.F of Kshs 200 p.m (Kshs 2,400 p.a)
- Subscriptions to professional associations such as LSK, ICPAK etc.

(b) MEMO FROM: TAX MANAGER
TO: MR. HESABU – TAX CONSULTANT AND DIRECTOR
REF: TAX CONSIDERATIONS ON POINTS RAISED BY CLIENTS

(i) Mr. Wote's taxable income is arrived at as follows:

Partnership profits reported	180,000
Add back interest to Watu and Wote (Sh.25,000 x 2)	50,000
Adjusted Partnership profit	230,000

Distributed as follows:

Partner	WATU	WOTE	WAD	TOTAL
	SH.'000'	SH.'000'	SH.'000'	SH.'000'
Interest on Capital	25	25	-	50
Balance of profits	54	54	72	180
	79	79	72	230

Therefore Mr. Wote's taxable income in equivalent to KShs. 79,000

(ii) Live Well Foundation being a Non-Governmental organization formed to address people's spiritual needs is of a Public character and sources of its income include donations, charitable walks and sale or religious literature and where such income is entirely expended in Kenya for the same purpose, no tax liability arises.

(iii) Liability to tax on farm income to wife rests with the husband. Secondly where farming is established to be hobby farming then losses will not be offset against tax. We are told that family consumption is Sh.60,000 for the year and that she derives a lot of satisfaction from this activity. This may be an indicator to hobby farming. However if 25% or less of the farm produce is consumed then profits are taxable. For year 2005 taxable farm profit would be computed as follows:

Profit year 2005	Sh. 50,000
Add: Own Consumption	Sh. 60,000
	Sh.110,000
Less loss b/fwd (40,000 loss – 20,000 profit)	Sh.(20,000)

Taxable farm income Sh. 90,000

Taxable farming income of Ksh.90,000 will be added to the husbands income and total assessed to tax on him.

(iv) By sponsoring research into plants to produce plastic related materials which they manufacture, New plastic Limited will be allowed to deduct the contribution against taxable income of such year of income. This reduces taxable income and tax liability. Section 15(i) (ii) (iv) states: 'a sum paid to a university, college, research institute research mentioned in sub-paragraph (iii):' as deductible against taxable income.

Signed
TAX MANAGER

QUESTION TWO

(a) (i)"Pay as You earn" is deductible from weekly wages, month salaries, annual salaries,bonuses, commissions, directors fees (whether the director is resident or non-resident) pensions paid to pensioners who reside in Kenya.

It is the employer's statutory duty to deduct income tax from the pay of his employees whether or not he has been specifically told to do so by the Department.

The law requires an employer to remit the income tax deducted from his employee's pay before the tenth day of the month following the deduction.

If the total amount of tax deducted, from all employees in any month is less than hundred shillings or when no tax has been deducted, the employer must complete the relevant portions of the top copy of a credit slip and send it direct to his Income Tax office before the tenth day of the following month.

Where total amount of tax deducted is less than Ksh.100, it should be carried forward to later months until it exceeds Ksh.100 or until December, whichever is the earlier, and then paid-in.

(ii) If any employer fails to comply with the provisions of Section 37 and with the provisions of any rules made under Section 130 which deals with the payment over of tax deducted and the accounting for it to the commissioner, the commissioner may, by order, impose a penalty equal to <u>twenty five per cent of the amount of tax involved</u> , and the provisions of the Act relating to the collection and recovery of the tax shall apply to the collection and recovery of any tax payable and such penalty as if it were tax due by the employer.

1. Cost of installing a ventilation system in the factory:

This is a capital expenditure (not allowable) since such installation would occur before the building is put into use and is thus capitalized.

2. Legal expenses incurred when acquiring a new building.

This is a capital expenditure. Such expenses are capitalized and disallowable since they are not incurred in generating taxable business income.

3. Giving the factory a new fresh coat of paint.

This is revenue expense since it is basically a maintenance cost used on a factory already existing and used in generating taxable income.

4. Replacing 200 tiles on a roof damaged by wind

This is allowable expense since tiles are replaced with tiles. If tiles are replaced with other roofing materials, the cost is treated as capital in nature hence disallowable.

5. Demolition cost to accommodate a new machine

This is a capital expenditure and should be capitalized as part of the qualifying cost of the machine. It is incurred before the machine is put into use. It is disallowable expense.

(b) **ROLES OF THE VAT TRIBUNAL**

The role of a value added tax tribunal is that of an appeals body for the purpose of hearing and deciding on appeals where a taxpayer is dissatisfied with the ruling by the commissioner for value added tax.

The appeals Tribunal has powers of a subordinate court of the first class to summon witnesses, to take evidence upon oath or affirmation and to call for the production of books and other documents.

QUESTION THREE

(a) A tax is a compulsory contribution by persons liable to pay tax to the state to defray the expenses incurred in the common interest of all, without reference to special benefits conferred. By compulsory we mean any person who refuses to pay a tax is liable to punishment. Tax revenue is used for the benefit of all and there is no direct 'Quid Pro Quo' payment.

The National social Security Fund is a government fund which was established by the National social Security Fund Act 1965 for the benefit of workers. It is a compulsory savings scheme into which the employer pays a statutory contribution for every employee who is a member of this fund. The scheme is applicable to those employers having five or more employees. The average rate of contribution is 10% of a worker's wages half of which is paid by the employer and half by the worker subject to a maximum of 2400p.a

The following benefits are provided under this scheme:

- Age benefits – paid to a member at age of sixty or when he retires from paid employment, whichever is later.
- Withdrawal Benefit – paid to a member who is at least fifty-five years of age and has not engaged in paid employment during the previous three months.
- Invalidity Benefit – Paid to a member who is permanently incapable of work because of physical or mental disability.
- Survivors Benefit – Paid to the dependants of deceased member
- Immigration Grants – Paid to a member who is permanently emigrating from Kenya.

(b) (i) Payment of pension from a registered scheme to a pensioner will be based on the following rules:

the first Ksh.300,000 received by a resident individual in a year of income in respect of pensions or retirement annuities is exempted and is not chargeable to tax.

Lump sum payment of first Ksh.600,000 is exempted from income tax upon maturity of employment.

(i) Payment to widow or widower of a pensioner will be treated as follows:

- the first Ksh.1,400,000 of such a lump sum payment will be consolidated income not chargeable to tax as income of the beneficiary.

(c) The following are the main rules relating to a registered Pension scheme – Sec.22:

(i) Deduction in respect of contributions of an employee in a year shall be limited to the lesser of:-

the sum of the contributions made by the employee to registered funds in the year, or thirty per cent of the employee's pensionable income in the year, or two hundred and forty thousand shillings per year

(ii) Pension funds in respect of an employee may be transferred to another registered fund or registered individual retirement fund and not be treated as a withdrawal under Sec.3 (2) ©.

(iii) Where registered fund is wound up, any surplus funds therein shall be deemed to be the funds of the employer and shall be immediately withdrawn by the employer unless the trust deed in respect of such registered fund specifies the contrary.

Other rules:

- Funds must be registered
- contribution cannot be withdrawn before 5 years have expired neither can contributions be used as security.

QUESTION FOUR

(a) Qualifying expenditure – the cost of the asset (used for generating taxable income) which should qualify for a capital allowance/deduction

The items to be included as qualifying expenditure include:

- Buying price of the asset
- Any customs duty and Vat paid on the asset
- Installation costs
- Insurance on transit and transport costs before the asset is brought into use
- Cost of demolition of a building to accommodate the asset
- Any repair cost incurred before the asset is brought into use
- As a rule, any incidental cost incurred before the asset is brought into use is a qualifying expenditure

(a) **Industrial Building – "Hotel"**

This is a hotel building or part of a hotel building which the Commissioner of Domestic Tax has certified to be an industrial building, including any building directly related to the operations of the hotel such as kitchens, staff quarters and entertainment and sporting facilities.

(b) **Exempt dividend income**

Dividends from outside Kenya

Dividends received by a company which owns 12½% or more of the voting power of the paying company.

Dividends received by an exempt person, e.g registered pension and provident funds

Dividends received by an insurance company from its life insurance fund

(c) **Non-Resident Individual**

Is an individual person who has a permanent home in Kenya and was not present in Kenya for any period during the year of income under consideration; or he has no permanent home in Kenya and was not present in Kenya for a period or periods amounting in aggregate to 183 days or more during the year of income under consideration; or he has no permanent home in Kenya and was present in Kenya for any period during the year under consideration and in each of the two preceding years for periods not averaging more than 122 days for the three years.

(d) **Memorandum of Appeal & Statement of Facts**

These are the most important documents (Memorandum of appeal and statements of facts) which must be submitted to the clerk of the Local Committee. Memorandum of appeal is a document stating the grounds/reasons for the appeal. The original and 9 other copies for the members of the Local Committee. A statement of facts, on the other hand, is a document which gives a sequence of events on the assessment before appeal to the local committee, i.e. dates assessment was issued and objected to, confirmed, etc.

QUESTION FIVE

(a) **Presumptive Tax on Agricultural Produce**

- This tax was levied on the value of gross sales of specified agricultural produce. Introduced in 1989 was charged at rate of 5% and collected by the authorized agents specified in the 19th sechdule of the Act. These agents are required to remit this tax to the commissioner in 30 days of making such deductions.
- This tax is charged under the provisions of Section 17 (a) of the Income tax Act and based on the presumption that farmers who grow certain crops or produce derive gains and profits chargeable to tax under Section 3 (2) (a).
- The rate was later reduced to 2% which was final tax in the case of individual farmers only.
- The tax complies with principles of a good tax in that gains to farmers are also brought to taxation in line with canon of equality/equity or fairness.
- It is convenient and economical since it is collected by authorized agents appointed by Government and that it is based on gross sales made. It is certain since it is collectable at points of sales of agricultural produce affected.

(b) **Cess on Agricultural Produce**

Is a levy imposed by Rural local authorities on traders of the main commodities found in such local authority such as Agricultural produce, building materials, e.g. Sand, Stones, Quarry chips. The purpose of the levy is to maintain roads and essential facilities provided by such local authority.

(c) **Trade Licence Chargeable to Professionals**

Trade licences fees are charged in accordance with provisions of Trading Licenses Act (Cap 497). These are licenses on annual basis to grant the permission to conduct professional work for a gain. This charge ensures that the right persons get the authorization to conduct professional work and protects such professionals from non-qualified persons who may wish to join the trade. It is convenient and economical since the licenses will normally be issued by the local authority concerned as a Government body. It may not be productive given few number of professionals require such permit per year but satisfies principle of equity or fairness as professionals desiring to practice are also brought into the tax net.

(d) Stamp Duties on Transfer of Premises

Stamp duties are charges by Government in respect of some documents which are specified in the Stamp Duties Act. Stamp duties are charged in Kenya in accordance with the provision of Stamp Duties Act Cap 480. Instruments must be stamped where property transfers are effected. Conveyance or transfer duty is charged on every instrument or court order in respect of the transfer of any property as a result of sale. Stamp duty on transfers of premises is equitable/fair since the property owners contribute tax, it is convenient since it is only applicable upon such transfer.