

## QUESTION ONE

(a) (i) **Direct Tax:**

- Impact and incidence is on the same person e.g. PAYE, imports or exports, corporate tax etc.
- Tend to be elastic

(ii) **Indirect Tax:**

- Impact and incidence falls on different persons.
- Tend to be inelastic since these taxes are imposed mainly on the necessities examples are VAT, custom duty etc.

(b) **Objectives of raising taxes**

- Pension of social and merit goods and services by the government such as roads, health, education etc.
- Efficient allocation of resources e.g. tax the rich more and use taxes to alleviate poverty among low income groups.
- To achieve monetary policies e.g. control rate of inflation by increasing taxes, and thus reducing disposable income available on individuals.
- Protect local industries e.g. raise the customs duty on imports to discourage consumption of import and encourage consumption of local goods and production.
- Creation of employment e.g. government could impose more taxes to reduce investment in private sector (“crowding out” effects) and invest more in public sector to create employment opportunities.

## QUESTION TWO

(a) Why accounting income is different from taxable income.

- Some income of capital nature e.g. capital gain is not taxable but it is part of accounting profits.
- Accounting profits are determined after deducting depreciation but from taxable income, we deduct capital allowances.
- Some accounting expenses are not allowable for tax purposes e.g. general provision for bad debts, capital loss, some legal fees etc.

- Released and unrealized profits – for tax purposes, we recognize realized foreign exchange gains/losses but accounting profits recognize both realized and unrealized gains (losses).

(b) (i) Mr. Somji Patel

**Practice Income**

Practice loss	(165,000)	
Add back:		
Salary to self	1,560,000	
Loan repayment	<u>480,000</u>	1,875,000

**Employment Income**

Salary 120,000 p.m x 6	720,000	
Housing benefit (30,000 x 6) or (15% x 720,000 x $\frac{6}{12}$ )	180,000	
	<u>(36,000)</u>	864,000
Less rent paid 5% x 720,000		
Less owner occupied mortgage interest lower of:		(50,000)
(i) 180,000 x 6/12 = 90,000		<u>18,000</u>
(ii) 100,000 x 6/12 = 50,000		2,707,000
Pension income [18,000 p.m – 15,000 (exempt)]x6		

Mrs. Patel Income:

$$30,000 \text{ p.m} \times 12 = \text{Sh.}360,000 \text{ p.a.}$$

(ii) **Tax payable**

Sh. 121,968 x 10%	12,196.8
Sh. 114,912 (0.15 + 0.2 + 0.25)	68,947.2
Sh. (2,707,000 – 466,704)	<u>672,089.0</u>
	753,233.0
Less: personal Relief	(13,944.0)
PAYE:	
On self salary	(444,600)
On employment	(204,000)
Pension (2,500 p.m. x 6)	<u>(15,000)</u>
Net tax liability	<u>75,689.0</u>

- (iii) - The tax is payable by 30 April 2006
- Paid by instalments through current year of income
- (iv) Information Unused:
  - The cost of house Sh.2,400,000
  - Dividends from Barclays Bank – Withholding tax is final tax
  - Mortgage interest – Sh.180,000 – maximum deductible is Sh.100,000
  - Wife's salary – Assumed wife opted to file her own return.

### QUESTION THREE

- (a) (i) - Commissioner may by notice in writing to inform that person of his intention to
  - apply to the Registrar of Lands or buildings to be the subject of security for tax of an amount specified in the notice.
- If a person fails to pay the whole of the amount specified in the notice within 30 days from the date of service of the notice, the commissioner may by notice in writing direct the Registrar of Lands that the land and buildings, to the extent of the interest there in must be the subject of security, for the tax of specified amount and the Registrar shall, without fee, register the direction as if it were an instrument of mortgage over, or charge on, as the case may be.
- Commissioner will write to the Registrar of lands to cancel the directive upon payment of the whole of the amount of tax secured.

Commissioner has right to sell property if VAT is not paid.

- (ii) **Where the commissioner has reasons to belief that there is:**
  - Uncertainty as to any question of law or fact
  - Bankruptcy or insanity of the debtors.
  - Impossibility due to undue difficulty or expense in recovery of tax.

### QUESTION FOUR

- (a) (i) **Taxation of Export Processing Zones (EPZ)**
  - 100% investment deduction on plant and machinery

- Exempted from Corporation tax for the first ten years
- Pay tax at a lower rate of 25% for the next 10 years
- Zero-rated for purposes of the VAT Act.
- Refund of import duty on imported raw materials to manufacture exports.

(ii) **Members clubs**

- Provided  $\frac{3}{4}$  or more of club income (i.e. entrance fees and subscriptions) comes from members, the club income will not be taxable.
- This excludes investment income such as dividends, interest and rent.
- They pay tax at corporate tax rate.

(b) (i) **Flora Ltd**

Taxable Profit for 2005

	<b>Sh.</b>	<b>Sh.</b>
Net Profit		1,548,800
Add back:		
Loss on sale of pick-up	36,000	
Legal expenses – Tax appeals	38,400	
Bad and doubtful debts	11,200	
Depreciation	<u>96,000</u>	<u>181,600</u>
		1,730,400
Less:		
Dividends	102,400	
Capital allowances	<u>84,000</u>	<u>(186,400)</u>
Adjusted profit		<u>1,544,000</u>

(ii) **Tax Payable:**

30% of 1,544,000 = Sh.463,200

(iii) **Final tax payable by 30 April 2006 (end of 4<sup>th</sup> month after year end).**

(iv) **Failure to submit S.A.R.**

- A late filing penalty of 5% of tax due subject to Kshs. 10,000 minimum.

**Failure to pay tax:**

- Late penalty of 20% of tax due

- Late payment interest of 2% per month
- Interest based on tax due plus, penalty.

## QUESTION FIVE

### (a) Simope Enterprises:

#### (i) Capital Allowances

Investment		Sh.'000'		
Deduction		Q. Cost	I.D @ 100%	Residual
Additional factory		2,400	2,400	-
building		500	<u>500</u>	-
Machinery			<u>2,900</u>	

#### (ii) Industrial Building Deduction: (Kshs. '000')

- Lifespan of building 40 years
- Balance – 36 years.
- Therefore Q. Cost for IBD =  $\frac{18M}{36yrs} \times 40yrs = 20M$
- Balance b/f =  $20m - \frac{20m}{40yrs} \times 4 = \underline{\underline{18M}}$

Building	Q. Cost	Bal b/f	IBD 2.5%	@	Bal c/f
Old F. Building	20,000	18,000	<u>500</u>		17,500
			<u>500</u>		

#### (iii) Wear and Tear Schedule

	Class I Sh.	Class II Sh.	Class III Sh.	Class IV Sh.
WDV 1.1.2005	1,093,750	3,125,000	2,187,500	2,980,000
Additions:				
Fax machine	-	45,000	-	-
Photocopier	-	180,000	-	-
Computer	-	250,000	-	-
Daewoo Car	<u>-</u>	<u>-</u>	<u>1,000,000</u>	<u>-</u>
	1,093,750	3,600,000	3,187,500	2,980,000

Disposals:	<u>(760,000)</u>	<u>(96,000)</u>	<u>(250,000)</u>	<u>(100,000)</u>
	333,750	3,504,000	2,937,500	2,880,000
Wear & Tear	<u>125,156</u>	<u>1,051,200</u>	<u>734,375</u>	<u>(360,000)</u>
WDV 31.12.2005	<u>208,594</u>	<u>2,452,800</u>	<u>2,203,125</u>	<u>2,520,000</u>

**Summary:**

	Sh.
Investment Deduction -	2,900,000
IBD -	500,000
Wear and Tear:	
Class I -	125,156
Class II -	1,051,200
Class III -	734,375
Class IV -	<u>360,000</u>
	<u>5,670,731</u>

(b) **Computation of Taxable Profit/Loss:**

	Sh.
Net profit	7,000,000
Add:	518,000
Partners salaries	1,650,000
Interest on capital	360,000
Depreciation	<u>265,000</u>
	<u>2,275,000</u>
	9,275,000
Less:	
Capital allowances	<u>(5,670,731)</u>
Profit	<u>3,604,269</u>

**Division among partners:**

	Simon	Peter	Total
	<b>Sh.</b>	<b>Sh.</b>	<b>Sh.</b>
Salary	750,000	900,000	1,650,000
Interest on capital	200,000	160,000	360,000
Share of profit (loss)	<u>797,134.5</u>	<u>797,134.5</u>	<u>1,594,269(Bal)</u>
	<u>1,747,134.5</u>	<u>1,857,134.5</u>	<u>3,604,269</u>

(c) **Tax Payable:**

	Simon	Peter
Sh.121,968 @ 10%	12,196.8	12,196.8
Sh.114,912 @ (15% + 20% + 25%)	68,947.2	68,947.2
Surplus (1,747,134.5 – 466,704) @ 30%	<u>384,129.0</u>	<u>417,129.0</u>
	465,273.0	498,273.0
	<u>(13,944.0)</u>	<u>(13,944.0)</u>
Less personal relief	<u>451,329.0</u>	<u>484,329.0</u>
Net tax liability		

(d) **Information not used:**

- Dividends received – WHT is final tax
- Cost and Net book value of disposed assets – Disposal proceeds used.