



CPA ADVANCED LEVEL

PILOT PAPER

ADVANCED TAXATION

December 2021.

Time Allowed: 3 hours.

Answer ALL questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings. Any assumptions made must be clearly and concisely stated.

RATES OF TAX (Including wife's employment, self-employment and professional income rates of tax).

Year of income 2020.

Assume that the following rates of tax applied throughout the year of income 2020:

Monthly taxable pay (Sh.)	Annual taxable pay (Sh.)	Rate of tax % in each Sh.
1 - 24,000	1 - 288,000	10%
24,001 - 40,667	288,001 - 488,000	15%
40,668 - 57,334	488,001 - 688,000	20%
Excess over - 57,334	Excess over - 688,000	25%

Personal relief Sh.2,400 per month (Sh.28,800 per annum).

Investment allowance:	Rate of investment allowance	Residual value (per year on reducing balance)	Prescribed benefit rates of motor vehicles provided by employer
Capital expenditure incurred on:			(i) Saloons, Hatch Backs and Estates
(a) Buildings:			Monthly rates (Sh.) Annual rates (Sh.)
• Hotel building	50% in the first year of use	25%	Up to 1200 cc 3,600 43,200
• Building used for manufacture	50% in the first year of use	25%	1201 - 1500 cc 4,200 50,400
• Hospital buildings	50% in the first year of use	25%	1501 - 1750 cc 5,800 69,600
• Petroleum or gas storage facilities	50% in the first year of use	25%	1751 - 2000 cc 7,200 86,400
• Educational/hostels building	10% per year on reducing balance		2001 - 3000 cc 8,600 103,200
• Commercial building	10% per year on reducing balance		Over - 3000 cc 14,400 172,800
(b) Machinery:			(ii) Pick-ups, Panel Vans (unconverted)
• Machinery used for manufacture	50% in the first year of use	25%	Up to - 1750 cc 3,600 43,200
• Hospital equipment	50% in the first year of use	25%	Over - 1750 cc 4,200 50,400
• Ships or aircraft	50% in the first year of use	25%	
• Motor vehicles and heavy earth moving equipment	25% per year on reducing balance		
• Computer software, calculators, copiers and duplicating machines	25% per year on reducing balance		
• Furniture and fittings	10% per year on reducing balance		
• Telecommunication equipment	10% per year on reducing balance		
• Film equipment by a local producer	25% per year on reducing balance		
• Machinery used to undertake operations under prospecting rights and exploration under mining rights	50% in the first year of use	25%	
• Other machinery	10% per year on reducing balance		
(c) Purchase/acquisition of right to use fibre optic cable by telecommunication operation	10% per year on reducing balance		(iii) Land Rovers/Cruisers 7,200 86,400
(d) Farm works	50% in the first year of use	25%	

Commissioner's prescribed benefit rates:

Services	Monthly rates (Sh.)	Annual rates (Sh.)
(i) Electricity (Communal or from a generator)	1,500	18,000
(ii) Water (Communal or from a borehole)	500	6,000
Agriculture employees: Reduced rates of benefits		
(i) Water	200	2,400
(ii) Electricity	900	10,800

QUESTION ONE

(a) Explain the meaning of “alternative dispute resolution”. (2 marks)

(b) All tax disputes can be resolved through alternative dispute resolution (ADR) with some exceptions.

With reference to the above statement, describe the exceptions. (6 marks)

(c) Omari Hassan has approached you as the tax expert, to advise him on which of the following two job offers to accept. Hassan has received two offers of employment both of which require him to report for duty next year on 1 January 2022.

He has provided you with the following information

Job offer A: Maua Growers Ltd.

Terms of employment:

1. A basic salary of Sh.1,680,000 per annum.
2. Free housing for him and his family within the farm, with free water and electricity. The water is from a borehole sunk in the farm. The electricity is also generated within the farm.
3. Free supply of the farm produce subject to a maximum value of Sh.50,000 per month.
4. Reimbursement of medical expenses incurred on self and family subject to a maximum of Sh.125,000 per month. The reimbursement policy only applies to the senior managers.
5. Payment of his children’s school fees amounting to Sh.180,000 per annum by the employer. The employer will not expense it in his books of account.
6. His annual subscription fee to the sports club amounting to Sh.50,000 would be paid for by the employer.
7. He would be required to register as a member of the Institute of Certified Public Accountants. The employer would pay the annual subscription fee of Sh.18,000.

Job offer B: Kilwa Dishes Ltd.

Terms of employment:

1. A basic salary of Sh.2,160,000 per annum.
2. Free housing and meals but only for self.
3. Monthly entertainment allowance of Sh.15,000.
4. Payment by the employer of his medical expenses subject to a maximum of Sh.800,000 per annum. The medical scheme covers all hotel employees.
5. Payment by the employer of his life assurance premiums amounting to Sh.5,000 per month.
6. Reimbursement by the employer of his annual subscriptions for the Journal of Certified Public Accountants amounting to Sh.2,500 per annum.
7. A one week fully paid holiday package worth Sh.150,000 for his wife and children to visit him and reside at the hotel once per year. The package would also include visits by the family to neighbouring tourist attractions.

Omari Hassan has further provided the following additional information:

- His annual average medical expenses are as follows:

	Sh.
Self	150,000
Wife and children	300,000
Total average medical expenses	450,000

- His consumption of the farm produce under job offer A would average about Sh.300,000 per annum.

Hint: Your evaluation should include both taxable and non-taxable benefits. Use year 2020 tax rates.

Required:

Evaluate the two job offers and advise Omari Hassan on which offer to accept based on expected net annual income. (12 marks)

(Total: 20 marks)

QUESTION TWO

- (a) Under Section 24 of the Income Tax Act, a company is required to adhere to the rules under the shortfall distribution. If a company is unable to pay the required amount, it has to make a representation to the tax department.

In relation to the above provision, explain four factors that must be included in its representation. (4 marks)

- (b) Explain the meaning of thin capitalisation in relation to an entity. (3 marks)

- (c) The management of Bituls Ltd. has received a notice from the Commissioner for Domestic Taxes stating that the company is subject to the income tax rules on thin capitalization. The management intends to object to the Commissioner's directive and have approached you for advice.

An extract of the company's statement of financial performance revealed the following:

	Sh."000"
Goodwill	43,500
Land	220,000
Plant and machinery	310,100
Office equipment	146,250
Inventory	88,890
Accounts receivable	97,890
Bank balance	29,210
Ordinary share capital	445,000
Share premium	53,000
Profit and loss	(42,300)
10% loan	1,650,000

Supporting your answer with suitable computations, advise the management of Bituls Ltd.:

- (i) On the possible outcome of its objection. (4 marks)
- (ii) The interest tax shield due to Bituls Ltd. based on your advice in (c) (i) above. (2 marks)
- (d) (i) Explain the taxable incomes of a life assurance company. (3 marks)
- (ii) The following information relates to Beta Life Assurance Company Limited for the year ended 31 December 2020:

The fund balance was valued by an actuary at Sh.220 million as at 31 December 2020. 40% of this fund balance was recommended to be transferred for the benefits of shareholders.

	Sh."million"
Received during the year	120
Outstanding as at: 1 January	60
31 December	40

Management expenses and commissions paid during the year amounted to Sh.40 million and Sh.6 million respectively.

The company had no other income during the year.

Required:

Taxable income of Beta Life Assurance Company Limited for the year ended 31 December 2020. (4 marks)
(Total: 20 marks)

QUESTION THREE

- (a) (i) Explain how a company operating in Kenya but with its headquarters in another country may avoid taxation through transfer pricing. (5 marks)
- (ii) A few countries and regions in the world have established themselves as tax havens. Briefly summarise three benefits that might accrue to an investor in a tax haven. (3 marks)
- (b) Mary and Khadija are in a partnership trading as Mahadi enterprises: They share profits and losses in the ratio of 3:2 for Mary and Khadija respectively.

The partners presented the following statement of profit and loss of the partnership for the year ended 31 December 2020.

	Sh.
Sales	8,400,000
Closing stock	1,176,000
Rental income	522,480
Dividend received (net)	54,240
Foreign exchange gain	54,960
Interest income (net)	120,000
Discount received	84,000
	<u>10,411,680</u>
Opening stock	960,000
Purchases	4,080,000
Salaries and wages	1,440,000
Insurance	288,000
Travelling expenses	187,200
Salaries and wages: Mary	720,000
Khadija	480,000
Rent rates	558,000
Interest expense	1,872,000
Goodwill written off	120,000
Medical expenses for partners	240,480
Legal expenses	144,240
Bank charges	91,680
Stamp duty	180,000
Loss on sale of equipment	19,200
VAT paid	39,120
Purchase of furniture	57,600
Depreciation	48,000
	<u>(11,525,520)</u>
Net loss	<u>(1,113,840)</u>

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Additional information:

- On 1 April 2020 Abby was admitted as a partner. She contributed Sh.960,000 as her share of capital and goodwill. The profit and loss sharing ratio was revised to 2:2:1 for Mary, Khadija and Abby respectively with effect from 1 April 2020. Abby was not entitled to a salary for the year ended 31 December 2020.

- Interest expenses comprised:

	Sh.
Interest on capital: Mary	432,000
Khadija	480,000
Abby	48,000
Interest on loan	672,000
Fridge benefit tax	240,000
	<u>1,872,000</u>

- All transactions relating to equipment and furniture occurred after 1 April 2020.
- All other revenues and expenses accrued evenly throughout the year.

Required:

- Determine the adjusted profit or loss of the partnership for the year ended 31 December 2020.

(8 marks)

- Allocate the profit or loss computed in (b) (i) above to the partners.

(4 marks)

(Total: 20 marks)

QUESTION FOUR

(a) BSI Fly High Ltd. presented the following trading results for the year ended 31 December 2020:

Statement of comprehensive income for the year ended 31 December 2020

	Sh. "million"	Sh. "million"
Turnover		70,743
Direct cost	44,376	
Fleet ownership	<u>9,102</u>	<u>(53,478)</u>
Gross profit		17,265
Other incomes		
Interest income (net)	372	
Fair value gains/losses on fuel derivatives	6,140	
Shares of results of associated company	77	
Gain/loss on hedged exchange differences:		
On borrowings	1,280	
Gain on hedged fuel contacts	<u>398</u>	<u>8,267</u>
Total income		<u>25,532</u>
Less: Expenses		
Overheads	15,426	
Finance cost	1,485	
Realised losses on fuel derivatives	3,771	
Other losses/gains	501	
Deferred taxation on cash flow hedges	503	<u>(21,686)</u>
Total profits/loss		<u>3,846</u>

Additional information:

1. Turnover includes	Sh. "million"
Passenger revenue	62,838
Freight and mail	5,434
Handling	1,312
Others	<u>1,159</u>
	<u>70,743</u>
2. Analysis of operating expenditure:	
• Direct cost	9,292
Aircraft fuel and oil	8,530
Aircraft landing, handling and navigation	14,555
Passenger services	4,445
Commissions on sales	3,246
Aircraft passenger and cargo insurance	366
Crew route expenses	1,742
Central reservation system (net) and frequent flier programme	1,805
Others	<u>395</u>
	<u>44,376</u>
• Fleet ownership costs	
Hire of aircraft and engines	5,920
Depreciation on air craft and engines	3,094
Depreciation on rotatables and other equipment	262
Amortisation of refurbishment costs	-
Air craft purchases subsidy	<u>(174)</u>
	<u>9,102</u>
Overheads	
Administration	10,175
Employee costs	348
Legal and professional fees	73
Director's remuneration	11
Audit fees	<u>1,492</u>
	<u>12,099</u>
Establishment	
General maintenance and supplies	1,163
Depreciation of buildings vehicle and other equipment	860
Amortisation of intangible assets and prepaid operating lease	<u>364</u>
	<u>2,387</u>

	Sh. "million"
Selling	
Advertising and publicity	665
Bad debts expense	<u>275</u>
	940
Total overheads	<u>15,426</u>

Required:

- (i) Compute adjusted taxable income for the year ended 31 December 2020. (10 marks)
- (ii) Tax payable, if any for the year. (2 marks)
- (b) (i) In Kenya, tax agents are individuals or companies that prepare taxes on behalf of the tax payers, they also offers professional assistance to people or companies that do not want to prepare taxes on their own.
- In light of the above statement, explain circumstances under which a tax agent's license may be canceled. (4 marks)
- (ii) Bandari Realtors' Ltd. provided the following information relating to the sale of their properties in the year 2020.
- Sale proceeds were Sh.2,000,000 and the incidental costs were; Legal fees - Sh.100,000; Advertisement - Sh.50,000; Agent's commission - Sh.200,000 and Valuation fees - Sh.150,000.
 - Cost of acquisition/construction was Sh.1,500,000 and the other relevant/ incidental costs were as follows: Legal cost on acquisition - Sh.60,000; Valuation - Sh.70,000; Costs to change the roof of property - Sh.130,000; Legal cost to defend title Sh.50,000; investment allowance had been allowed totaling Sh.450,000 over the years.

Required:

Compute the capital gains tax.

(4 marks)

(Total: 20 marks)

QUESTION FIVE

- (a) Explain the challenges in implementing special economic zones (SEZs). (8 marks)
- (b) Customs audit is the process of verifying that the business is in compliance with the customs legislation through the examination of books and records of a business to prevent commercial fraud.
- In relation to the above statement, explain the objectives of a customs audit. (4 marks)
- (c) In case of back duty the tax department will reject the accounts presented to them and will advise the taxpayer to provide another set of accounts prepared by a reputable firm of auditors. Where presentation of accounts is not possible, the taxpayer's income could be computed through capital statements.

Required:

Explain other circumstances under which capital statements are applicable in computation of income. (4 marks)

- (d) Outline the documents which must accompany a claim for VAT refund under Section 24 (Bad Debts). (4 marks)

(Total: 20 marks)

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