

# KASNEB

## CPA PART III SECTION 6

### ADVANCED PUBLIC FINANCE AND TAXATION

THURSDAY: 26 November 2015.

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 2014.**

Monthly taxable pay (Sh.)		Annual taxable pay (Sh.)		Rate of tax % in each Sh.
1	- 10,164	1	- 121,968	10%
10,165	- 19,740	121,969	- 236,880	15%
19,741	- 29,316	236,881	- 351,792	20%
29,317	- 38,892	351,793	- 466,704	25%
Excess over	- 38,892	Excess over	- 466,704	30%

Personal relief Sh.1,162 per month (Sh.13,944 per annum)

#### Prescribed benefit rates of motor vehicles provided by employer

	Monthly rates (Sh.)	Annual rates (Sh.)
<b>Capital allowance:</b>		
<b>Wear and tear allowance:</b>		
Class I	37.5%	
Class II	30%	
Class III	25%	
Class IV	12.5%	
Software	20%	
<b>Industrial building allowance:</b>		
Up to 2009	2.5%	
From 1 January 2010	10%	
Hotels	10%	
Hostels/Education buildings	50%	
From 1 January 2010-		
Commercial building:		
(Shop, office or show room)	25%	
<b>Farm works allowance</b>	100%	
<b>Investment deduction allowance</b>	100%	
<b>Shipping investment deduction</b>	40%	
<b>Mining allowance:</b>		
Year 1	- 40%	
Years 2 - 7	- 10%	

#### Commissioner's prescribed benefit rates

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

### QUESTION ONE

- (a) A recent study on public financial management in developing countries identified a growing interest by governments to establish and enhance public private partnerships (PPPs) as one of the ways of achieving sustainable development. In some of the countries covered by the study, a public private partnership (PPP) unit had been established within the mainstream government structure.

**Required:**

- (i) Explore three possible reasons for the growing interest in public private partnerships particularly among developing countries. (3 marks)
- (ii) Explain three functions of a public private partnership unit as established by a government. (3 marks)
- (iii) Summarise three challenges likely to face the implementation of public private partnerships in your country. (3 marks)
- (b) Country X has undertaken a number of infrastructural projects as part of its long-term development initiatives. This has however resulted in the government borrowing heavily from both the domestic market and the foreign market. As a result, interest rates have risen significantly, a situation that has affected other critical sectors of the country's economy.

**Required:**

In the context of the above scenario, advise the government of Country X on four approaches that it could use to manage its public debt. (8 marks)

- (c) In the context of monitoring of public projects by public entities, outline three objectives of electronic project monitoring information systems (e-PROMIS). (3 marks)

**(Total: 20 marks)**

### QUESTION TWO

- (a) In recent times, public financial management has generated a lot of interest from governments, the public, donors among other stakeholders.

**Required:**

Discuss four distinctive features of financial management in the public sector as compared to the private sector. (8 marks)

- (b) According to legislation on investment promotion, an applicant may apply for an investment certificate from a public investment board.

**Required:**

In the context of the above statement:

- (i) Outline three conditions that an applicant is required to fulfill in order to obtain an investment certificate. (3 marks)
- (ii) Describe five areas that could be considered by the public investment board before grant of an investment certificate. (5 marks)
- (c) Citing two examples, discuss the relevance of the international financial market in the context of public financial management in your country. (4 marks)

**(Total: 20 marks)**

### QUESTION THREE

James and Katana established a partnership business, sharing profits and losses in the ratio of 3:2 respectively. The following is the income statement of the partnership for the year ended 31 December 2014:

	Sh.	Sh.
Sales		6,728,000
Unrealised foreign exchange gain		150,000
Capital gain on sale of shares		352,000
Recovery from insurance on stock stolen		480,000
Goods transferred to a branch at cost		184,000
Dividends from Kali Cooperative Society		<u>51,000</u>
		7,945,000

	Sh.	Sh.
Less expenses:		
Purchases	2,842,000	
Purchase of computers	180,000	
Partners salaries	720,000	
Legal fees	680,000	
Repairs and maintenance	568,400	
Rent and rates	244,600	
Interest on loan	166,200	
General expenses	964,000	
Motor vehicle expenses	840,000	
Insurance	156,000	
Preliminary expenses	262,800	
Directors fees	600,000	
Audit fees	148,200	
Debenture interest	360,000	
Travelling expenses	<u>96,000</u>	<u>8,828,200</u>
Net loss		<u>(883,200)</u>

**Additional information:**

1. The partnership was converted into a limited liability company by the name Kaka Ltd. on 1 October 2014. Incomes and expenses accrued evenly throughout the year unless otherwise stated.
2. Purchases and sales were inclusive of value added tax at a rate of 16%.
3. Closing stock was valued at Sh.1,840,000 while opening stock was at 10% of sales net of value added tax.
4. Legal fees comprised:

	Sh.
Petition to Association of Manufacturers	80,000
Notice for change of business name	64,800
Conveyance fees of business premises	72,400
Stamp duty	36,600
Negotiating a business loan	20,800
Recovery of bad debts	45,000
Signing a 100-year lease agreement	128,400
Purchase of partner's private residence - James	150,000
Appeal against tax arrears	<u>82,000</u>
	<u>680,000</u>
5. Repairs and maintenance comprised:

	Sh.
Purchases of furniture	96,000
Installation of neon sign	60,000
Designing an office block	140,000
Cost of partitioning office block	250,000
Repainting of business premises	<u>22,400</u>
	<u>568,400</u>
6. General expenses included; registering of patent rights Sh.64,000, floatation costs Sh.48,000 and negotiating costs for an additional piece of land for business expansion at Sh.56,000.
7. Interest on loan includes interest on partners' capital of Sh.100,000 which was shared according to profit and loss sharing ratio.

**Required:**

- (a) A statement of adjusted taxable profit or loss for the business for the year ended 31 December 2014. (14 marks)

**Hint: Start with gross profit.**

- (b) Comment on the tax position of James, Katana and the company. (4 marks)
- (c) Citing examples, advise James and Katana on two areas of tax avoidance that they could explore for the business. (2 marks)

**(Total: 20 marks)**

**QUESTION FOUR**

- (a) Highlight four factors to be considered when selecting an appropriate transfer price. (4 marks)

(b) Mjengo Ltd. is in the real estate business. During the year ended 31 December 2014, the company acquired ten houses each at Sh.4,000,000 before incurring the following expenses:

- 10% interest on mortgage loan of Sh.10,000,000.
- Conveyance fees for each house Sh.40,000.
- Estate agent's valuation fees per house Sh.28,000.
- Repairs undertaken for two houses Sh.44,000.
- Cost of repainting the houses Sh.84,000.
- The impairment loss of the houses was estimated at Sh.150,000.
- Legal expenses amounting to Sh.36,000 were incurred in defending a title for a house with defective ownership documents.

Mjengo Ltd. sold each house at Sh.5,800,000. The cost for advertising the houses was Sh.160,000, estate agent's commission Sh.180,000, insurance Sh.72,000, valuation fees Sh.150,000 and legal fees Sh.148,000.

**Required:**

Determine the following:

- (i) Transfer value. (3 marks)
- (ii) Adjusted cost. (3 marks)
- (iii) Capital gains tax. (1 mark)
- (iv) Due date for filing of capital gains tax. (1 mark)

(c) Rigs Drilling Ltd. is a mining company dealing with petroleum products. During the year ended 31 December 2014, the following details were extracted from the company's financial statements:

	Sh"000"
Geological costs	84,680
Exploratory drilling costs	146,400
Acquisition costs	19,800
Lifting costs	12,600
Lease operating costs	64,780
Costs of refining crude oil	18,240
Oil and natural gas revenue	9,840,000
Depletion and depreciation	34,980
Share based compensation	24,670
General and administrative expenses	78,340
Reversal of litigation expenses	9,680
Finance expenses	6,400
Decommissioning costs	4,280
Drilling machines	18,300
Investment income	464,000
Impairment losses	5,680
Intangible drilling costs	3,420
Professional fees	2,600
Loan repayment	840
Tractor	1,500
Derivatives oil losses	480
Restructuring expenses	848
Forklift	1,800

**Additional information:**

1. Intangible drilling costs include Sh.420,000 for a well which failed to yield crude oil and was abandoned.
2. Restructuring expenses include Sh.582,000 paid to a consultancy firm that restructured the capital structure of the company.
3. Exploratory drilling costs include:
  - Plant and machinery Sh.4,800,000.
  - Erection of rigs and tankage Sh.1,600,000.
  - Pipes and storage tanks Sh.9,480,000.
  - Factory building Sh.48,400,000.
4. Professional fees include Sh.800,000 for services provided by the general manager of the parent company.

**Required:**

A statement showing the taxable profit or loss for the year ended 31 December 2014.

(8 marks)

(Total: 20 marks)

**QUESTION FIVE**

(a) Summarise three legal provisions relating to double taxation relief as applicable in your country. (3 marks)

(b) Lima Ltd. is a company incorporated in your country. The company controls 80% of the share capital of Shamba Ltd. which is also incorporated in your country. The following is a statement of comprehensive income of Lima Ltd. for the year ended 31 December 2014:

	Sh. "000"	Sh. "000"
Gross profit		59,220
Less:		
Depreciation	4,872	
Legal expenses	508	
Loan interest	819	
Electricity	378	
Salaries and wages	9,387	
Telephone	357	
Patent royalties paid	756	
Travel expenses	<u>785</u>	<u>17,862</u>
		41,358
Other income		
Patent royalties received	2,772	
Loan interest received	193	
Dividend received from Shamba Ltd.	<u>5,628</u>	<u>8,593</u>
Net income		<u>49,951</u>

**Additional information:**

1. The loan interest paid included the following:
  - Interest of Sh.285,000 relating to a loan acquired to purchase office equipment.
  - Interest of Sh.258,000 relating to a loan used to acquire shares of Shamba Ltd.
2. Salaries and wages include passages of Sh.1,008,000 paid to a director who relocated to another country.
3. Travel expenses include Sh.155,000 paid to a new employee hired from a foreign country.
4. The loan interest received relates to a loan issued to an employee of the company to purchase a residential house.
5. Not included in other income was rent received of Sh.1,638,000 from one lease, gross of a loss of Sh.397,000 made on another lease.
6. An operating loss of Sh.189,000 had been carried forward for the previous eight years. This loss was included in salaries and wages expense as at 31 December 2014.
7. Royalties of Sh.145,000 were due for receipt as at 31 December 2014 but had not been recorded in the books.
8. Legal expenses included:
  - Sh.176,000 paid on disposal of some property and equipment.
  - Sh.48,000 incurred on debt collection.
  - Sh.78,000 incurred on defending the company against a claim for breach of contract.
9. Patent royalties received were from Shamba Ltd. while those paid were to a Ugandan company.
10. Capital allowances for the year ended 31 December 2014 were agreed with the commissioner at Sh.1,932,000.

**Required:**

A statement of adjusted taxable profit or loss for the year ended 31 December 2014. (10 marks)

(c) Amos Akida, a businessman, is facing a tax investigation by the revenue authority which suspects that he has been under-declaring income for the four years from year 2011 to year 2014.

You are the head of a team from the revenue authority conducting an investigation on Amos Akida. He has submitted to your team records of his private and business assets and liabilities from 1 January 2011 to 31 December 2014 as shown below:

	1 January 2011	31 December 2011	31 December 2012	31 December 2013	31 December 2014
	Sh. "000"	Sh. "000"	Sh. "000"	Sh. "000"	Sh. "000"
<b>Assets and liabilities</b>					
Factory premises	48,000	54,000	56,000	52,000	54,000
Plant and machinery	24,000	25,000	38,000	34,000	36,000
Motor vehicle (commercial)	12,000	14,000	14,000	15,000	20,000
Inventory	4,600	5,200	9,000	10,000	8,000
Trade receivables	3,950	4,540	3,640	3,530	3,980
Private residence	8,240	14,600	14,600	14,600	14,600
Trade payables	7,280	8,640	9,420	8,360	7,890

	Sh. "000"	Sh. "000"	Sh. "000"	Sh. "000"	Sh. "000"
Bank loan	10,900	10,000	9,870	7,640	9,840
Loan from a friend	800	700	600	870	640
Mortgage loan	3,780	3,780	3,780	3,780	3,780
Cash balance	3,400	5,400	3,600	3,760	4,670

**Additional information:**

1. The cash balance on 31 December 2012 included Sh.600,000 inherited from a relative on 30 August 2012.
2. His living expenses for each of the four years were as follows:

**Year ended 31 December:**

	2011	2012	2013	2014
Living expenses (Sh.)	85,000	140,000	90,000	165,000

3. Interest on mortgage is at the rate of 15% per annum.
4. There were no disposals of non-current assets during the period under investigation.

**Required:**

Taxable income of Amos Akida for each of the four years ended 31 December 2011, 2012, 2013 and 2014.

Ignore capital allowances.

(7 marks)

**(Total: 20 marks)**

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