CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 2 EXAMINATIONS

A2.3: ADVANCED TAXATION

MONDAY: 8 JUNE 2015

INSTRUCTIONS:

1. **Time Allowed: 3 hours 45 minutes** (15 minutes reading and 3 hours 30 minutes writing).
2. This examination has two sections; A & B.
3. Section A has one Compulsory Question while section B has four optional questions to choose any three.
4. In summary attempt four questions.
5. Marks allocated to each question are shown at the end of the question.
6. Show all your workings

TAX RATES AND ALLOWANCES:

The following rates of tax and allowances are to be used when answering the questions

Personal Income Tax Rates

Monthly Taxable Income		**Tax Rate**
From	**To**	
0	Frw 30,000	0%
30,001	Frw 100,000	20%
100,001	and above	30%

Individual's housing benefit: 20% of the employment income excluding benefits in kind

Individual's Car benefit: 10% of the employment income excluding benefits in Kind

National Social Security Contribution

Employees contribution	3%
Employer's contribution	5%

Corporate Income Tax Rate

30%

Capital gains tax

Net aggregate gains are taxable at the company rate of tax

Value Added Tax Rate

18%

Annual tax depreciation allowances

Depreciable assets	**Rate**
Land, fine arts, antiquities, jewellery and any other assets that are not subject to wear and tear or obsolescence.	0%
The cost of acquisition or construction and the cost of refining, rehabilitation, reconstruction of buildings, equipment and heavy machinery fixed in walls	5%
The cost of acquisition or development and the cost of improvement, rehabilitation, and reconstruction of intangible assets including goodwill that is purchased from a third party	10%
Computers and accessories, information and communication systems, software products and data equipment	50%
All other assets (the tax depreciation is granted on reducing balance basis).	25%

Investment Allowance	**Rate**
Investment within Kigali	40%
Investment within priority sectors, or registered business located outside Kigali.	50%

SECTION A

This section has one compulsory question

QUESTION ONE

One of the major reasons behind regional integration arrangements is to create large investment areas and enlarge markets. This demands that cooperation be promoted in areas that priorities enlargement of trade and investments opportunities within a regional arrangement. The East African Community (EAC) comprising of Burundi, Kenya, Rwanda, Tanzania and Uganda has prioritised the harmonisation of taxation regimes of the Community Member States. EAC countries have some huge differences in their tax systems including definitions of their tax bases. These differences sometimes confer unfair tax competition and unequal treatment of tax payers, goods and services in the region, which if not addressed will distort the effective functioning of the Common Market.

Harmonisation of tax policies and laws on domestic taxes is, therefore, an important aspect of macroeconomic convergence that is also one of the benchmarks to be attained for effective functioning of a Common Market. According to Article 32 of the EAC Common Market Protocol, harmonisation of EAC tax regimes is expected to *"facilitate the freemovement of goods, services, and capital, and the promotion of investments within the Community"*. If, indeed, harmonisation of national tax regimes within a regional context were underpinned by the desire to *promote investments* in the region and if the *free movement of goods, services, and capital,* were to directly benefit the people of East African Community, then the debate ought to refocus on the source and magnitude of investment that the region intends to promote through this exercise and for whose goods and services should the expanded regional market benefit most.

In this perspective, more benefits would accrue directly or indirectly to the people of East Africa through the promotion of local investment, use of local content and economic growth that is spurred through native entrepreneurship and investment. Preferably, therefore, the debate within the harmonisation of EAC taxation regimes should pay attention to whether the achieved convergence of tax regimes will not only promote foreign direct investments, but also, and more importantly, whether it will promote local small business development within the region. However, since most small businesses within the region fall within the informal economy, it should concern the EAC whether the agreed taxation regimes will foster the creation of a "culture of taxation" and an "expanded formal sector" so that native entrepreneurship and investment can contribute effectively in spurring economic growth to be realised in the region. On this account alone, it should concern the EAC whether the convergence on taxation regimes offers incentives to small businesses in the region to move from informality to formality. Here again, the argument we seek to advance in this research is that for a region like EAC where the informal sector is almost as large as the formal sector and dominated by Micro, Small and Medium Enterprises (MSMEs), a good harmonised regional taxation system will be one that also provides incentives for formalisation of SMEs by establishing taxation systems that will foster small business development with the aim of catalysing regional economic growth.

In addition to that, the structure of the private sector in the EAC region is dominated mainly by MSMEs, operating mainly informally. In developed economies, most MSMEs have been brought within the tax radar through formalisation via specific reform measures which have included simplification and reduction in tax compliance burden. On the other hand, in developing economies such as EAC countries, the task is more difficult in that MSMEs are not generally compliant (due to ignorance as well as intent) nor are they easily located by the tax administration; most operate within the informal sector. For most of these informal small businesses, the choice to pay tax or remain in the informal sector would be a simple one; stay in the informal sector as long as possible because the perceived benefits outweigh the perceived costs. If compliance costs - both financial and time - are added into their cost benefit analysis of paying taxes, the disincentive to comply with tax requirements becomes even stronger. However, is it really so hard to develop a favourable tax system to appropriately tax MSMEs?

Despite the fact that the diverse activities of MSMEs are widely noticeable as a source of livelihood for many, a number of issues have been raised about the sector. Concerns in all the EAC member states have basically revolved around legitimacy of the activities when they are carried out in an informal environment where their implications and impact on the entire economy cannot easily be ascertained. Majority of the firms in the sector do not fulfill business registration requirements and tax obligations. However, adverse tax environment for MSMEs discourage these enterprises from conducting their business in a formal manner; hence, their contribution to the economies of EAC is by and large underrated since most of their work is not captured in the official statistics.

The above contributions of the sector to the EAC tie the future welfare of the EAC to a vibrant MSME sector. This belief is captured in the statement that this sector plays "a vital role in contributing to renewed economic growth of the country".

The expanding national budgets also create the need to increase revenue collection. This can be easily achieved by expanding the tax base rather than increasing the tax rates.

Bringing the informal sector into the tax net is the most feasible approach to achieving a broader tax base. There are indeed more compelling reasons for the small entrepreneur and the government to join the tax net. However, most MSMEs from the region especially the informal ones, do not know about these benefits and governments, too, do not see the benefits of creating systems that favour formalisation of and compliance by small businesses to taxation.

REQUIRED:

a) Based on the above case explain the informal economy, micro enterprise, small and medium enterprises, culture of taxation and expanded formal sector. **(10 Marks)**

b) Highlight the major issues raised in the case study as regard to tax system in the community. **(15 Marks)**

c) If you were a policy maker, what would you do to formalise informal sector **(10 Marks)**

d) What are the tax implications of free mouvement of goods, services and capital in the East African community. **(5 Marks)**

(Total 40 Marks)

SECTION B

This section has four questions to attempt any three

QUESTION TWO

AFC Ltd was incorporated in Rwanda, Eastern Province in 2011. The company deals in manufacturing, importing and exporting of hardware and finishing materials for houses. In the year 2014, the company sold goods worth Frw 4,114,575,000. Out of the total sales, 70% were exports to the East African Community. In the same year, the company had deposits (savings) of Frw 1,200,000,000 in a commercial bank in Rwanda and earned interest at the rate of 9.25%. As a requirement, when a saving is made, commercial banks issue deposit certificate indicating the date of deposit and maturity, owner of deposit, amount deposited and interest rate. For AFC Ltd, all the certificates, which had different maturity dates, indicated a total of Frw 1.2 Billion. In August 2014, 63% of the deposits have matured. AFC Ltd employed 176 permanent staff and more than 700 casual labour. AFC operates in its own building or factory that was completed in 2012. The total cost of the factory is Frw 1.1 Billion. This excludes the section for the warehouse which is under construction. The warehouse section is estimated to cost Frw 350 million on completion. AFC Ltd rented motor vehicles worth Frw 300 million in 2013. The factory building started to be depreciated in 2012 financial year. AFC Ltd secured investment certificate from the Rwanda Development Board totalling to Frw 7 Billion in 2010. The investment certificate was for six years and is still valid.

In accordance with the customs laws, an importer with no tax clearance certificate "Quitus fiscal" must pay withholding tax at customs. AFC Ltd paid Frw 120 million withholding tax at customs and Frw 76 million on public tender. It also paid Frw 42 million withholding tax on services of engineers who were outsourced from Mauritius and South Africa. Rwanda has a Double Taxation Agreement (DTA) with Mauritius and South Africa. AFC Ltd does not pay customs duties on goods imported from the East Africa Community (EAC) when the company presents the certificate of origin. Other expenses incurred by AFC Ltd were; provisions for staff leave of Frw 72 million, airtime for staff on duty of Frw 32 million, expenses for staff canteen totalling to Frw 44 million. AFC Ltd paid Frw 3 million to Ugandan Association in Rwanda. The company has a special tax calendar of October to September.

REQUIRED:

a) Compute the corporate income tax payable by AFC Ltd for the year ended September 2014 **(12 Marks)**

b) Calculate the quarterly prepayments for the subsequent year and advise on the date(s) that AFC Ltd should pay the quarterly prepayments. **(3 Marks)**

c) Discuss briefly five criteria under which imports from the EAC may qualify for the rules of origin. **(5 Marks)**

(Total 20 Marks)

QUESTION THREE

You are a tax manager for one of the big four accounting firms that offer tax, audit and advisory services. You have received the following information from a potential investor in UK (BOENET Export Ltd) who would like to penetrate into the Rwandan Market. The investor who deals in medicine would like tax advice on the following:

Background – Current BOENET operations

BOENET Export Ltd (UK incorporated and UK tax resident company) currently makes sales to a third party distributor in Rwanda (there are also a minor amount of sales by other BOENET group companies including a Kenya incorporated entity). There are 4 individuals based in Rwanda that perform information gathering and information dissemination activities. All contracts with the distributor in Rwanda are executed by BOENET outside of Rwanda (e.g. BOENET Export contracts with distributors will be executed in the UK).

Proposal

BOENET Export Ltd is looking at establishing a manufacturing facility in Rwanda. The facility would initially perform secondary packaging of medicine for domestic distribution in Rwanda, and export to Burundi and DRC. The site would also have a warehouse for all BOENET products.

BOENET Export Ltd intends to acquire a plot of land in Huye District of Rwanda as the first step so that all required planning for the construction of the manufacturing facility can be undertaken. It is anticipated that the majority of the building materials and equipment for the site will be imported. Local labour will be used to construct the facility. BOENET Export Ltd may employ some individuals to manage/oversee the construction of the manufacturing facility that will be performed by a third party entity. The individuals employed may continue working at the manufacturing site once it's operational. During the period of construction no manufacturing or other type of activity would be undertaken relating to the site. However, the BOENET Group would continue to sell its products to third party distributors through the existing BOENET companies as mentioned in the 'Background' section above.

In the longer term (if not the preferred option for the initial land purchase) BOENET would incorporate a legal entity in Rwanda to perform the following:

- Import and export of products
- Employ staff for manufacturing and commercial operations (once the site is constructed)
- Engage in selling and marketing activities for BOENET products in Rwanda (i.e. the activities currently undertaken by BOENET Export or other BOENET Group companies).

Advice required

As BOENET does not currently have any legal presence in Rwanda it needs to consider how the acquisition of land should be performed. The options may include the following (you may consider any other option you may think of);

1) BOENET incorporates a subsidiary entity in Rwanda to make the acquisition (assume that this entity will be 100% owned by a BOENET UK company)
2) Use a BOENET overseas company to acquire the land (assume for the purpose of the advice that the overseas company is UK incorporated and tax resident). This overseas company could then transfer the land to a Rwanda subsidiary once incorporated.
3) Use a trusted third party in Rwanda to acquire the land on behalf of and for the exclusive benefit of BOENET. Once the new BOENET Rwanda entity is incorporated this entity would acquire the land from this third party. An option arrangement may be required to ensure the BOENET Rwanda entity is able to acquire the land from the third party.

REQUIRED:

a) For each option above, you are required to advise on the following:

i) Any tax registration requirements including the timelines for completing such registrations. **(6 Marks)**

ii) Any tax implications for the existing activities of BOENET Export Limited in Rwanda. **(3 Mark)**

b) Direct and Indirect tax implications (including customs duties) on the following:

i) Land purchase **(1 Mark)**

ii) Importation of construction materials **(1 Mark)**

iii) Local construction costs incurred **(1 Mark)**

c) Payroll tax implications in respect of individuals employed for the construction phase. **(8 Marks)**

NB: With regards to the VAT implications please ensure that the following points are covered:

i) Is it possible for an entity to register for VAT before it starts trading for VAT in advance of the purchase of land?

ii)Would any VAT incurred be recoverable, and if so when i.e. is it immediately recoverable or would recovery be deferred until the company starts trading? **(Total 20 Marks)**

QUESTION FOUR

a) Ingo Ltd, a company incorporated in Rwanda, has recently purchased Microsoft Software Licenses from a vendor in Tanzania. These were supplied to a Customer in Rwanda. The Licenses did not pass through the Customs as it is just an indication by Microsoft through email to the customer interest.

REQUIRED:

Discuss the taxes applicable on this transaction **(6 Marks)**

b) Article 2 of law n° 78/2008 of 31/12/2008 on direct taxes on income states that in the case of a taxpayer other than an individual, some interest paid on loans and advances from related entities is not deductible. Sake Ltd is a company incorporated in Rwanda in accordance with the Rwandan laws. In 2014, the company obtained loans totalling to Frw 970 million and paid interests amounting to Frw 300 million. Out of this amount, Frw 600 million was obtained from the shareholder who is based in Switzerland. The related interest for loans from the shareholder was amounting to Frw 120 million. Sake Ltd's share capital is Frw 10 million only. This share capital excludes reserves and retained earnings.

REQUIRED:

Compute the interest that Sake Ltd is allowed to expense in its financial statements in accordance with the income tax law of Rwanda. **(10 Marks)**

c) Yuhi Farms Ltd sells beans in Rwanda. Compute the taxes applicable to Yuhi Farms Ltd if it sold unprocessed beans worth Frw 16 million in the year 2013, assuming that this taxpayer did not file the income tax return on grounds that beans are exempt from taxes and has been advised to file in June 2015 to avoid further accumulation of interests. **(4 Marks)**

(Total 20 Marks)

QUESTION FIVE

Vision 2020 Company Ltd operates in banking sector activities and it is located at Kimironko area. For the year ended December 31, 2014, the Finance Director has approached you as an expert in taxation to advise his company on the different taxes to be paid for such year and provided the following:

Vision 2020 **Statement of comprehensive income** **For the year ended December 31, 2014**			
	Notes	**2014** **Frw**	**2013** **Frw**
Interest income	1	51,909,827	45,210,752
Interest expense	2	-12,654,600	-10,015,908
Net interest income		**39,255,227**	**35,194,844**
Net Fees and commission income	3	10,899,154	10,801,253
Foreign exchange related income		7,724,325	7,476,135
Other operating income	4	301,838	281,008
		18,925,317	**18,558,396**
Operating income before impairment losses		**58,180,544**	**53,753,240**
Net impairment on loans and advances		-7,542,957	-8,993,999
Net operating income		**50,637,587**	**44,759,241**
Personnel costs	5	-14,427,737	-11,707,238
Depreciation and amortisation	6	-3,663,534	-4,639,637
Administration and General expenses	7	-9,787,611	-9,656,130
Total operating expenses		**-27,878,882**	**-26,003,005**
Profit before income tax		22,758,705	18,756,236

Notes to the accounts

		2014 **Frw**	**2013** **Frw**
1	**Interest income**		
	Interest on overdrawn accounts	10,016,733	9,882,349
	Interest on treasury loans	4,765,373	4,235,125
	Interest on equipment loans	4,871,114	3,838,218
	Interest on consumer loans	7,049,062	6,465,347
	Interest on mortgage loans	15,545,839	12,259,456
	Other interest on loans to clients	4,687,629	4,904,323
	Interest on deposits with banks	980,580	262,585
	Interest received from reverse purchase agreements	771,890	1,423,824
	Interest on assets held to maturity	3,221,607	1,940
		51,909,827	**43,273,167**
2	**Interest expense**		
	Interest on borrowings (BACLAYS BANK - UK)	2,475,389	1,621,764
	Interest on current accounts and saving accounts	981,936	1,089,855
	Interest on fixed deposits	9,197,275	7,304,289
		12,654,600	**10,015,908**
3	**NET FEES AND COMMISSION INCOME**		
	Fees and commission income		

	Commissions on operations of accounts	2,358,216	2,639,702
	Commissions on payment facilities	2,718,969	3,198,971
	Commissions on loan services	2,812,701	2,168,032
	Commissions received from financing commitments	498,853	595,613
	Commissions received from guarantees commitments	989,272	1,078,380
	Income from transactions with other banks	321,348	309,383
	Other fees from services	1,387,494	1,206,525
		11,086,853	**11,196,606**
	Fees and commission expense		
	Commissions on credit services	(86,304)	(320,524)
	Commissions for a consultant from England	(101,395)	(74,829)
		(187,699)	**(395,353)**
	Net Fees and Commission	**10,899,154**	**10,801,253**

4	**Other operating income**		
	Rental income	154,064	256,149
	Dividend received from investment	54,254	-
	Gain on asset disposal	84,496	24,753
	Other income from banking activities	9,024	105
		301,838	**281,007**
5	**Personnel costs**		
	Salaries and wages (Gross)	13,139,596	10,768,740
	Medical expenses	401,361	267,395
	Pension scheme contributions	612,140	501,736
	PAYE	274,640	169,367
		14,427,737	**11,707,238**
6	**Depreciation (according to company policy)**		
	Depreciation of property and equipment	3,469,943	4,303,044
	Amortisation of intangible assets	193,591	336,593
		3,663,534	**4,639,637**
	Total depreciation allowed by RRA	3,752,000	4,892,000
7	**Administration and general expenses**		
	Directors' Remuneration	357,209	400,945
	Audit Fees	38,263	50,485
	Rent, repairs and Maintenance	1,126,239	989,909
	Utilities	424,148	413,575
	Postage, Photocopying and printing	1,019,184	976,003
	Travel and Accommodation Expenses	387,965	365,550
	Security and cash in transit costs	1,318,946	1,075,778
	Insurance	104,423	94,716
	Marketing and Publicity	583,618	468,987
	Legal and Consultancy Fees	405,289	362,978
	Unclaimed VAT on expenditure	727,212	721,802
	Telephone and Internet costs	774,395	737,361
	Credit and Visa card Costs	1,256,392	1,179,237
	Other general expenses	1,264,328	1,818,804
		9,787,611	**9,656,130**

Additional information

- Included in other general expenses are fine for late declaration and payment of VAT declation for the month of July 2014 for the amount of Frw 300,000.
- The account Marketing and publicity includes an invoice of Frw 200,000 related to the overseas publicity in Jeune Africa magazine.
- Telephone expenses does not include the invoice of December 2014 equivalent to Frw 70,400.
- The bank has contracted a foreign loan in BACLAYS UK which he pays monthly interest of Frw 206,284.
- The bank received dividend from a resident company of Frw 30,000 and the remaining dividend was received from investment in a foreign company.
- Rental Income is derived from the rent of buildings and the latter are incorporated as assets.

REQUIRED:

a) Determine the adjusted taxable profit/loss for the company **(12 Marks)**

b) Advise the Finance Director on other taxes resulting from the information provided, and calculate them if any. **(8 Marks)**

(Total 20 Marks)

End of question paper

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