TAXATION PROGRAMME EXAMINATIONS

DIPLOMA LEVEL

D6: TAX AUDIT AND INVESTIGATIONS

MONDAY 13 JUNE 2016

TOTAL MARKS – 100; TIME ALLOWED: THREE (3) HOURS

INSTRUCTIONS TO CANDIDATES

1. You have fifteen (15) minutes reading time. Use it to study the examination paper carefully so that you understand what to do in each question. You will be told when to start writing.
2. This question paper consists of **FOUR (4)** questions of Twenty Five (25) marks each. You must attempt all the **FOUR (4)** questions.
3. Enter your Student number and your National Registration Card number on the front of the answer booklet. Your name must **NOT** appear anywhere on your answer booklet.
4. Do **NOT** write in pencil (except for graphs and diagrams).
5. **Cell Phones** are **NOT** allowed in the Examination Room.
6. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and depth of the answer.
7. All workings must be done in the answer booklet.
8. Present legible and tidy work.
9. Graph paper (if required) is provided at the end of the answer booklet.
10. A Taxation table is provided on pages 2, 3 and 4.

Taxation Table

Income Tax

Standard personal income tax rates

Income band	**Taxable amount**	**Rate**
K1 to K36,000	first K36,000	0%
K36,001 to 45,600	next K9,600	25%
K45,601 to K70,800	next K25,200	30%
Over K70,800		35%
Income from farming for individuals		
K1 to K36,000	first K36,000	0%
Over K36,000		10%
Gratuity		
K1 to K36,000	first K36,000	0%
Over K36,000		25%
Terminal benefits		
K1 to K35,000	first K35,000	0%
Over K35,000		10%

Company Income Tax rates

On income from manufacturing and other	35%
On income from farming	10%
On income of Banks and other Financial Institutions	35%
On income from mineral processing	35%
On income from mining operations	30%

(Variable profit tax rate) $y = 30\% + [a - (ab/c)]$

Where:
y = the tax rate to be applied per annum
$a = 15\%$
$b = 8\%$
$c = \frac{\text{Assessable Income}}{\text{Gross sales}} \times 100\%$

Mineral Royalty

Underground Mining operations	6%
Opencast Mining operations	9%
Mining of industrial minerals	6%

Capital Allowances

Implements, plant and machinery and commercial vehicles:

Wear and Tear Allowance –	Plant used normally	25%
	Used in Manufacturing, Farming, Leasing	50%

Non- commercial vehicles

Wear and Tear Allowance	20%

Industrial Buildings:	
Wear and Tear Allowance	5%
Initial Allowance	10%
Investment Allowance	10%
Low Cost Housing (Cost up to K20,000)	
Wear and Tear Allowance	10%
Initial Allowance	10%
Commercial Buildings	
Wear and Tear Allowance	2%
Farming Allowances	
Development Allowance	10%
Farm Works Allowance	100%
Farm Improvement Allowance	100%

Presumptive Taxes

Turnover Tax	3%

Property Transfer Tax

Rate of Tax on Realised Value of property other than mining rights	5%
Rate of Tax on Realised Value on a transfer or sale of a mining right	10%

Value Added Tax

Registration threshold	K800,000
Standard Value Added Tax Rate (on VAT exclusive turnover)	16%

Customs and Excise

Duty rates on:

1. **Motor cars and other motor vehicles (including station wagons) principally designed for the transport of less than ten persons, including the driver:**

   Customs Duty:

Percentage of Value for Duty Purposes	30%
Minimum Specific Customs Duty	K6,000

   Excise Duty:

Percentage of Value for Duty Purposes for Excise Duty Purposes	
Cylinder capacity of 1500 cc and less	20%
Cylinder Capacity of more than 1500 cc	30%

2. **Pick-ups and trucks/lorries with gross weight not exceeding 20 tones:**

   Customs Duty

Percentage of Value for Duty Purposes	15%
Minimum specific Customs Duty	K6,000

   Excise Duty:

Percentage of Value for Duty Purposes for Excise Duty Purposes	10%

3. Buses/coaches for the transport of more than ten persons

Customs Duty:

Percentage of Value for Duty Purposes	15%
Minimum Specific Customs Duty	K6,000

Excise Duty:

Percentage of Value for Duty Purposes for Excise Duty Purposes	
Seating Capacity of 16 persons and less	25%
Seating Capacity of 16 persons and more	0%

4. **Trucks/lorries with gross weight exceeding 20 tonnes**

Customs Duty:

Percentage of Value for Duty Purposes	15%

Excise Duty:

Percentage of Value for Duty Purposes for Excise Duty Purposes	0%

5. Surtax

On all motor vehicles aged more than five (5) years from year of manufacture	K2,000

Attempt all FOUR (4) questions

QUESTION ONE

(a) Income verification is important for a tax audit, as tax auditors will rely on income tests, because any understatement of income, will also cause an understatement of tax to be paid to the Zambia Revenue Authority (ZRA). Some of the methods that the tax auditors use, apart from analytical review and investigative approach, are the indirect methods that are used to verify the accuracy of income.

Required:

Explain the five (5) indirect methods that are used to verify income. (10 marks)

(b) Working papers should be readily available and identifiable so that other auditors are able to follow without the need to ask for further details. They should be clear, legible and easy to understand and should include among other things profiling checks, records of interviews and bank analyses. However, working papers should conform to certain qualitative characteristics.

Required:

Explain any five (5) qualitative characteristics of good working papers. (5 marks)

(c) Compliance management does help tax auditors to achieve equal treatment of tax payers and makes use of available human, financial and technical resources. Therefore compliance risk management processes can be viewed as a continuous loop.

Required:

List four (4) steps that can be followed by a tax auditor in the compliance risk management process. (2 marks)

(d) Explain the following terms in relation to risk assessment:

(i) Tax investigation (3 marks)
(ii) Risk assessment (2 marks)
(iii) Systems based approach (3 marks)

[Total: 25 marks]

QUESTION TWO

(a) Describe the nature of each one of the following and explain their tax implications:

(i) Operating lease;
(ii) Sale and lease back;
(iii) Finance lease.

(6 marks)

(b) Explain the impact of the following telecommunication concessions and charges on the VAT liability of a company in this sector:

(i) Discounts to Air Time Dealers;
(ii) Discounts to Subscribers;
(iii) Roaming Charges and Income. (3 marks)

(c) Although **Olipa Twambo** has run a small business for many years. She has never kept adequate records. However, a need to obtain a bank loan for the expansion of the business has necessitated the preparation of the 'final' accounts for the year ended 31 December 2016. As a result, the following information has been obtained after much careful research.

Olipa Twambo's business assets and liabilities are as follows:

As at	**1 Jan 2016**	**31 Dec 2016**
	K	K
Inventory	8,600	16,800
Account receivable	3,900	4,300
Accounts payable for purchases	7,400	8,300
Rent prepaid	300	420
Electricity accrued due	210	160
Balance at bank	2,300	1,650
Cash in hand	360	330
Van	4,000	3,200

The Original cost of the Van is K4,000

(1) All takings have been banked after deducting the following payments:

	K
Cash Drawings – Olipa Twambo has not kept a record of cash Drawings, but suggests there will be in the region of	7,290
Casual Labour	1,200
Purchase of goods for resale	1,800

Note: Takings have been the source of all amounts banked.

(2) Bank payments during the year ended 31 December 2016 have been summarized as follows:

	K
Purchases	101,500
Rent	5,040
Electricity	1,390
Delivery Costs (Customers)	3,000
Casual Labour	6,620

(3) It has been established that a gross profit of 33½% on cost has been obtained on all goods sold.

(4) Depreciation on the van is charged at the rate 20 % per annum on straight line basis.

Required:

(i) Prepare a computation of total purchases for the year ending 31 December 2016; (2 marks)

(ii) Prepare a statement of profit or loss for the year ending 31 December 2016 in as much detail as possible; (10 Marks)

(iii) Advise Olipa Twambo, based on the answer to part (ii), on the amount of Income Tax payable for the Tax year 2016, giving reasons for your answer. (4 marks)

[Total: 25 Marks]

QUESTION THREE

(a) List five (5) circumstances that would trigger a transfer pricing audit. (5 Marks)

(b) Define the term "Associated Enterprises" with respect to transfer pricing. (2 Marks)

(c) The Mining Fiscal regime as revised in the year 2008 introduced the concept of "Norm Value".

Required:

(i) Explain the meaning of "Norm Value" with respect to Mineral Royalty. (6 marks)

(ii) Explain the regime for capital allowances that is applicable to mining companies on qualifying capital expenditure. (2 marks)

(iii) State the circumstances when expenses on Environmental Rehabilitation and Restoration incurred by a mining company can qualify for tax deduction under the Income Tax Act. (2 marks)

(d) During the year ended 31 December 2015, Star Gemstone Ltd incurred a mining loss of K4,000,000, while an exchange rate on the same day was K5.21 to a dollar ($). The kwacha was trading at K4.10 on 31 December 2016. The exchange rate is the Bank of Zambia mid-rate for December 2016 and Star Gemstone Ltd prepares financial statements to 31 December each year.

Required:

(i) Explain why mining companies are given indexation allowance for losses and capital allowances. (2 marks)

(ii) Calculate the indexed loss available for relief for the tax year 2016. (3 marks)

(e) Explain the current status of Development Agreements (DA's) signed between the Government of the Republic of Zambia (GRZ) and mining investors on the privatisation of the Zambia Consolidated Copper Mines (ZCCM). (3 marks)

[Total: 25 Marks]

QUESTION FOUR

(a) Directors and other managers of the company have a duty to ensure that they supervise the company efficiently in order to maximize the profits for the shareholders. They are also in charge of ensuring that internal controls in place are working efficiently. Some of the responsibilities are contained in the statutes or Companies Act.

Required:

Explain any three (3) duties of directors that are embodied or found in the statutes or companies Act. (3 marks)

(b) In order to develop an effective and efficient audit strategy, the auditor needs to evaluate matters that are significant to the internal controls and financial statements.

Required:

Explain any five (5) matters of significance that external auditors need to evaluate.

(10 marks)

(c) For a tax audit to be appreciated, certain performance objectives and measures need to be put in place. These measures show whether the Zambia Revenue Authority (ZRA) compliance strategies and audit strategies are working towards the achievement of intended objectives.

Required:

(i) Outline two (2) categories of time measures in relation to a tax audit. (2 marks)

(ii) Explain three (3) roles of team leaders in relation with reviewing that correct procedures are being followed and reviews done. (3 marks)

(d) Explain the provisions in the Zambian tax legislation that act as a safeguard against abuse of:

(i) Loans to Effective Shareholders. (4 marks)

(ii) Loans from Shareholders. (3 marks)

[Total: 25 Marks]

END OF PAPER

JUNE 2016: TAX AUDIT AND INVESTIGATIONS (D6)

SOLUTIONS

SOLUTION ONE

(a) The following are the methods:

(i) **Source and application of funds method (also known as the T- account method).**

This method involves reconstructing income to determine the actual tax liability and is an analysis of a tax payer's cash flows and comparison of all known expenditures with receipts for the period. Net increases and decreases in assets and liabilities are taken into account along with non-deductible expenditures and non-taxable income over the sum of reported and unreported taxable income. It is suitable when the expenditure appears out of proportion to the income reported.

(ii) **Bank deposit and cash expenditure method-**

Under this method, we compute income by analysing what happened to a tax payer's funds. It is based on the theory that if a tax payer received money, only two things can happen, it can either be deposited or spent. This is based on the assumption that the proof of the deposit into the bank, after certain adjustments have been made for non-taxable receipts, constitutes evidence of taxable receipts. This method can be used in the examination of income tax returns.

(iii) **Mark-up method-**

This method is based on the use of ratios or percentages considered typical for the business under examinations, in order to make the actual determination of the tax liability. It consists of the application of appropriate percentage of mark-up to arrive at the tax payer's gross receipts. This method can overcome the weaknesses of the bank deposit/cash expenditure methods and others, which do not effectively reconstruct income when cash is not deposited and the total cash outlays cannot be determined unless volunteered by the tax payer. The method is recommended when inventory are the principal income producing factor and the tax payer has non-existent or unreliable records.

(iv) **Unit and volume method.**

In many instances, gross receipts may be determined or verified by applying the sales price to the volume of the business done by the tax payer. The number of units or volume of business done by the tax payer might be determined from the tax payer's books or records. The records under examinations may be adequate regarding cost of sales and expenses. In some cases information may be obtained from third parties.

(v) **Net worth method-**

This method is based on the theory that increases in tax payer's net worth during a tax year, adjusted for non- deductible income may result from taxable income. The method requires that the reconstruction of the tax payer's financial history, since all assets and liabilities need to be accounted for during the relevant period.

(b) Characteristics or features of working papers.

(i) Methodical continuity-
Working papers should provide space or areas that would allow for future comparisons and entries.

(ii) Clarity of purpose**-**

Working papers need to provide a clear and concise explanation of what purpose they intend to achieve.

(iii) Description-
A description of the content or purpose of the sheet and period of concern.

(iv) Evidence-
Working papers should have evidence of all significant verification activities' detailing what was actually done.

(v) Simplicity-
They should be simple for the tax auditors to cross reference information and each page should be numbered.

(c) The following are the steps:

i. Analysis
ii. Prioritization
iii. Treatment
iv. Evaluation

(d) **The following are the explanations:**

i. **Tax investigation** is a detailed examination by the tax authority or tax auditor into the tax records of the tax payer. This is conducted in order to discover any understatement of income in the previous years of assessment. There should be mainly an event or suspicion that should trigger investigation e.g. tax evasion.

ii. **Risk assessment** –this is a stage in the audit planning process where the auditor determines the likelihood and possibility of recording an inappropriate opinion in an audit as a result of misstatement in the financial documents examined. It determines when and how the audit should be conducted and by who. Risk assessment is done when the audit risk approach is used or undertaken.

iii. **Systems based approach** - This is an approach mainly used for medium and large enterprises and is based on the assumption that such Enterprises have control systems on which the preparation of financial statements is based. In most small organizations, systems based controls are almost non-existence, substantive tests can be used. Substantive tests involve extensive verification of transactions.

SOLUTION TWO

(a) The following are the explanations and tax implications:

(i) **Operating Lease**;

An operating lease is an agreement similar to a typical rental agreement on a real property where the lessee has the right to use the asset in return for lease rentals over the lease term. However, the legal ownership of the leased asset remains with the lessor, and therefore, the lessor is entitled to claim capital allowances on the same leased asset. The lessor is also responsible for maintenance and insurance of the asset and those expenses are generally tax allowable/deductible. Lease rentals are fully tax deductible and VAT is claimable for the lessee.

(ii) **Sale and Lease Back**;

The business sells an aset it owns and then enters into a lease with a financial institution so as to continue using the asset it earlier sold. The leased asset is available for

use by the company for the period of the lease at an agreed rental. The business h as the asset and has also raised funds. The lessor charges VAT on the capital component of the lease rental, which is claimable. Only the finance charges are tax deductible.

(iii) **Finance Lease**.

Finance lease is an arrangement where all the risks and rewards of ownership are substantially transferred to the lessee. The lessee is responsible for maintenance and insurance of the leased asset. The costs incurred by the lessee on the leased asset are all allowable for tax purposes. In addition the lessee claims capital allowances. The lessee claims the input VAT on the cost of the leased asset. The interest income is taxable on the lessor.

(b) The impact on the VAT and income tax liability is as follows:

(i) **Discounts to Air Time Dealers**;

As an allowance to the dealer for bulk buying or prompt payment, etc, a discount will not form part of the gross sales value charged. It will therefore both be income tax allowable and not subject to the VAT workings.

(ii) **Discounts to Subscribers;**

As an allowance to the subscribers , a discount will not form part of the gross sales value charged. It will, therefore, both be income tax allowable and not subject to the VAT workings.

(iii) **Roaming Charges & Income.**

This entails charging both the caller and receiver. Tax treatment will depend on when income arising from this facility is accrued or recorded. The roaming charges due to the Zambian entity will be liable to both income tax and VAT when received.

(c) **Olipa Twambo**

(i) computation of total purchases for the year ending 31 December 2016;

	K
Opening Creditors, Purchases	(7,400)
Payments, Cash	1,800
Payments, Bank	101,500
Closing Creditors, Purchases	8,300
Total	**104,200**

(ii) Statement of profit or loss for the year ending 31 December 2016

	K	K
Sales (K96,000 plus 33.5% Mark Up)		128,160
Less: COGS-		
Opening Stocks	8,600	
Purchases	104,200	
Less: Closing Stocks	(16,800)	
Cost of sales		(96,000)
Gross Profit		32,160
Expenditure:		
Rent (300+5,040-420)	4,920	
Casual Labour (1,200 +6,620)	7,820	
Electricity (160+1,390-210)	1,340	
Delivery Charges	3,000	
Depreciation (20% of K4,000)	800	
Total expenses		(17,880)
Net Profit		**14,280**

(iii) Tax payable by Olipa Twambo for the Charge Year 2016.

Olipa Twambo was required to pay turnover tax for the tax year 2016 because her annual turnover was not more than K800,000.

Turnover tax = K128,160 X 3%
=K3,845

This should have been paid on a monthly basis. For electronic returns payments should have been made not later than 14th day of the month following the month to which the tax relates (not later than 5th for manual returns)

SOLUTION THREE

a) The following are the circumstances that would trigger a Transfer Pricing Audit.

- Enterprises which have significant amount of or various types of related party transactions;
- Enterprises which have been in long-term consecutive losses, low profitability, or fluctuating profit and loss situations;
- Enterprises whose profit levels are lower than those in the same industry;
- Enterprises showing an obvious mismatch between their profit levels and their functional and risk profile;
- Enterprises which have business dealings with related parties in tax havens;
- Enterprises which have not complied with the reporting of their related party transactions or preparation of contemporaneous documentation; and
- Enterprises obviously violating the arm's length principle.

b) Associated enterprise, in relation to another enterprise, means an enterprise which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

c) (i) The Norm value is:

(1) The monthly average London Metal Exchange Cash price per metric tonne multiplied by the quantity of the metal or recoverable metal sold;
(2) The monthly average Metal Bulletin cash price per tonne multiplied by the quantity of the metal or recoverable metal sold to the extent that the metal price is not quoted on the London Metal Exchange; or
(3) The monthly average cash price per metric tonne of any other exchange market approved by the Commissioner-General multiplied by the quantity of the metal or recoverable metal sold to the extent that the metal price is not quoted on the London Metal Exchange or Metal Bulletin."

(ii) Normal rates of wear & tear allowances are at 25%(per annum) on straight line basis. This has been reduced from 100% in prior years, making capital expenditure fully claimable over four (4) years after purchase.

(iii) The following are the circumstances:
When funds have been specifically set aside for this (through say the EPF); or

When actual restoration works are done and expense incurred.

(d) **Indexation allowance**:

(i) Indexation allowance is provided because mining companies are allowed under the Income Tax Act to keep books of accounts in United States dollars, where at least 75% of their gross sales is from outside Zambia. Hence, in order to avoid exchange losses, since their tax return is submitted in kwacha, indexation for capital allowances and losses is provided.

(ii) Indexed loss =(1+ (R2-R1)/R1) X Loss b/f
(1+ (4.1-5.21)/5.21) X K4,000,000
=K3,147,793

(e) These agreements were signed between 1997 & 2000. Overall, DA offered mining companies comparatively both low tax rates and investment risk exposure, making Zambia an attractive and tax competitive mining investment destination. In 2008, the Zambian government unilateraly abolished the DA's, relegating them to be subsiary to the domestic tax legislation. This did not go very well with the affected mining companies, who have sought recourse via international arbitration. A final outcome has not yet been reached.

SOLUTION FOUR

(a) The following are the duties:

(i) They are in charge of keeping books of accounts and proper accounting records from which financial statements are prepared .e.g. Income statement and a statement of financial position.

(ii) They are ultimately in charge of the preparation of financial statements.

(iii) They are in charge of producing a director's report which is in consistent with financial statements. The report should also contain certain specific information which could be non-financial in nature so that the decision makers can make informed decisions.

(iv) They are in charge of development and implementation of internal controls over financial reporting.

(b) The matters should be evaluated:

(i) Matters affecting the industry in which the company operates such as financial reporting practices, economic conditions, laws and regulations, and technological changes.

(ii) Matters relating to the company's business including its organization, operating characteristics and capital structure.

(iii) The extent of the recent changes, if any, in the company's operations or its internal controls over financial reporting.

(iv) The auditor's preliminary judgments about materiality and risks, and in integrated audits, other factors relating to the determination of material weaknesses.

(v) Control deficiencies previously communicated to the audit committee or management.

(c) (i) The following are the time measures:

(i) Those measuring the direct ease case time taken for each audit, enabling an overall average case time to be computed for specific types of audit.

(ii) Those measuring the average direct case time of audits relating, noting that some of the time spent by audit staff cannot be related to individual cases.

(iii) Those measuring the time elapsed for each audit, i.e. the time between audit commencement and audit completion.

(ii) The following are the roles:

(i) They ensure the consistent application of delegated authority, audit standards, policy, procedures and their interpretation of audits.

(ii) Act as change champions and immediate leaders for organizational change and training /development of auditors.

(iii) Take a mediation role in dispute between the tax payer and the auditors.

(d) The following are the provisions:

(i) Loans to Effective Shareholders

Tax authorities world over have been concerned by companies arranging loans in a way that seeks to avoid tax. Thus they have developed safety nets within the tax legislation. The Income Tax Act (ITA) provides taxation of company loans (including current accounts) to effective shareholders at 35% of the gross value of the loan. Loans to associates of shareholders (related parties) are also treated similarly. If the loan is repaid to the copmpany, the tax paid on the loan is refunded.

(ii) Loans from Shareholders

Not to be confused with loans to shareholders. Debt-like financing by shareholders ranks low in company debt portfolio, with long maturity dates and low returns, and as such they are normally treated as equity. The company may need debt loan relief (leverage) and a tax shield (deductibility of interest payments). Other than the related party, no specific legislative provision exists in the ITA, probably because such arrangements are considered of low tax risk in practice.

END OF SOLUTIONS