TAXATION PROGRAMME EXAMINATIONS

DIPLOMA LEVEL

D6: TAX AUDIT AND INVESTIGATIONS

MONDAY 14 DECEMBER 2015

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 processing of purchased mineral ores, concentrates and other semi-processed minerals	30%
On income from Tolling	30%
On income from mining operations of industrial minerals	30%

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

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	8%
Opencast Mining operations	20%
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%

Presumptive tax for transporters

Seating capacity	Tax per annum K	Tax per day K
Less than 12 passengers and taxis	1,200	3.20
From 12 to 17 passengers	2,400	6.60
From 18 to 21 passengers	4,800	13.20
From 22 to 35 passengers	7,200	20.00
From 36 to 49 passengers	9,600	26.00
From 50 to 63 passengers	12,000	32.80
From 64 passengers and over	14,400	39.40

Property Transfer Tax

Rate of Tax on Realised Value of property other than mining rights	10%
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:	25%
	Excise Duty:	
	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	15%
	Excise Duty	10%
3.	Buses/coaches for the transport of more than ten persons	
	Customs Duty:	15%
	Excise Duty:	
	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:	15%
	Excise Duty:	0%

The minimum amount of Customs Duty on Motor Vehicles in categories from 1 up to 3 above is K2,000

ATTEMPT ALL FOUR (4) QUESTIONS

QUESTION ONE

You should assume that today's date is 20 January 2016 and that the Bank of Zambia discount rate is 12.75% per annum.

Jasper Kondolo, who is married and has four children, is a new client who has recently approached you for advice.

During the course of your discussions with him, he informs you that the Zambia Revenue Authority have recently written to him giving notice of their intention to make an enquiry into his Self- Assessment income Tax Return for the tax year 2014. This letter also warned that penalties and interest may be payable.

You further ascertain that Jasper worked as an employee of a firm of plumbers until 31 March 2014, when he resigned to start his own business, running a building hardware supply shop. The shop commenced trading on 1 July 2014, with accounts being made up to 31 December each year. The first accounts prepared by Jasper show the following:

	Note	Period ended 31/12/2014 K	Year ended 31/12/2015 K
Sales	1	760,000	1,050,000
Purchases	2	(380,000)	(470,000)
Gross Profit		380,000	580,000
Overheads:			
Shop rent & rates	3	(80,000)	(120,000)
Utilities	5	(12,000)	(22,000)
Motor Van expenses	4	(120,000)	(40,000)
Salaries	5	(96,000)	(180,000)
Sundry expenses	3	(100,000)	(20,000)
Net Profit / (Loss)		(28,000)	198,000

Note 1

Sales accrue evenly over time.

Note 2

These comprise the cost of all materials purchased in the respective periods. You further ascertain that:

1) The inventory figures at 31 December 2014 and 2015 respectively were K40,000 and K20,000.

2) The purchases figure for the year ended 31 December 2015 includes:

(i) Materials costing K38,000 used in the refurbishment of Jasper's own bathroom. The retail value of these materials amounted to K70,000.

(ii) Materials costing K30,000 consumed in the course of plumbing work undertaken (see below). The retail value of these materials amounted to K55,000.

Note 3

The figures for the period ended 31 December 2014 include a returnable rent deposit of K20,000 payable at the commencement of a three year lease and the cost of shop fittings and a computer amounting to K24,000 and K6,000 respectively.

Note 4

The motor van expenses figure of K120,000 includes K20,000 which had to be spent on repairing the motor van before it could be used in the business and the purchase cost of a motor van amounting to K60,000 used 90% for business purposes.

Note 5

Salaries includes Jasper's drawings of K10,000 per month and the salary paid to his wife of K6,000 per month, both commencing July 2014. His wife stopped working for him at the end of June 2015 and was replaced by a shop assistant performing the same duties earning K4,000 per month.

Jasper had notified the Commissioner General of the commencement of his business. They were notified on 31 July 2014 and ZRA issued a return of provisional income for the charge year 2014, to Jasper, on 31 August 2014. Jasper prepared this himself using the figures for the period ended 31 December 2014 and claiming a loss of K28,000 to carry forward to the tax year 2015. He filed the return of provisional income for the charge year 2014, with the Commissioner General on 31 March 2015. Jasper filed the self-assessment income tax return for the charge year 2014 on 30 September 2015. Pending the outcome of their enquiries, the Zambia Revenue Authority have not yet issued any tax refunds in respect of the loss claim made.

The return of provisional income for the charge year 2015, was issued in January 2015 and Jasper completed it with the figures for the year ended 31 December 2015 after claiming a deduction for his loss of K28,000 for the first six months of trading and filed it with the Commissioner General on 31 March 2015. He has paid the total provisional income tax of K44,680 in respect of the charge year 2015, on the normal due dates.

Jasper has no other income except as indicated above.

Required:

As a Tax Auditor working on Jasper's tax affairs, prepare notes for a meeting to be held with Jasper:

(a) Explaining any tax adjustments which need to be made to Jasper's accounts figures for the period ended 31 December 2014 and year ended 31 December 2015. Your answer should include a calculation of the revised tax adjusted business profit figures for each of these periods of account. (18 marks)

(b) Advising Jasper of any Income Tax that he should have paid for both the tax year 2014 and the tax year 2015. (2 marks)

(c) Explaining Jasper's position regarding his exposure to potential penalties and interest. Calculations of the amount of interest or penalties are not required. (5 marks)

You should assume that the various taxes rates for the charge year 2015 apply throughout.

[Total: 25 marks]

QUESTION TWO

(a) A tax payer in Zambia is expected to perform certain roles that can contribute to the efficient operation of the tax system. A tax payer is therefore, not only expected to pay the relevant taxes, but also perform other responsibilities required by law as well.

Required:

Explain the six (6) roles of the tax payer's audit programme. (6 marks)

(b) Explain two (2) circumstances under which a Tax Investigation will be initiated. (2 marks)

(c) Explain six (6) types of audits that can be conducted by a tax auditor. (6 marks)

(d) Discuss six (6) causes of the sanctions that can be imposed on a tax payer if they do not comply with relevant provisions of the tax law. (6 marks)

(e) Explain any five (5) key principles that can be applied in order to come up with a quality tax audit. (5 marks)

[Total: 25 marks]

QUESTION THREE

Mwansa Kunda has been in business for many year, selling beddings and furniture to the local community. She has presented the following statement of profit or loss for the year ended 31 December 2015:

	K	K
Sales Revenue		980,500
Less cost of goods sold:		
Opening Inventory	235,000	
Purchases	325,000	
	560,000	
Less closing inventory	(265,000)	
Cost of goods sold		(295,000)
Gross Profit		685,500
Less expenses:		
Salaries	125,000	
Repairs and renewals	45,600	
Rent and rates	34,000	
Bad debts	12,300	
Depreciation of furniture and fittings	9,800	
Interest payable	5,600	
Motor vehicle running expenses	6,900	
Light and heat	3,900	
Professional fees	12,400	
Subscriptions and donations	6,500	
General expenses	3,000	
Total expenses		(265,000)
Net Profit		420,500

Required:

(a) As a tax auditor working on the above results, describe the additional information that you would need in order for you to determine the tax adjusted profit, explaining why you would need that information. (18 marks)

(b) Explain why it is difficult to determine fair assessments for sole traders' businesses and discuss whether it may be easier to determine fair assessments for companies. (3 marks)

(c) Discuss whether the external auditor performing a statutory audit would be required to verify the tax computations of their client. (4 marks)

[Total: 25 marks]

QUESTION FOUR

Audit of telecommunication entities provide significant challenges to tax auditors. Internet connectivity and inter-connection charges can increase the cost of service provision by the network provider. However, at the end of the day, the network provider needs to recover the costs incurred.

Required:

(a) Discuss the consequences of inter-connection charges on VAT liability. (3 marks)

(b) Briefly explain the tax treatment of the following :

(i)	Discounts to Air time dealers	(4 marks)
(ii)	Discounts to subscribers	(4 marks)
(iii)	Network switch expenditure	(4 marks)
(iv)	Roaming charges and income	(4 marks)

(c) Briefly describe any two (2) classes of lease agreements (3 marks)

(d) Explain what is meant by converted exchange differences and foreign exchange earnings. (3 marks)

[Total: 25 marks]

END OF PAPER

D6: TAX AUDIT AND INVESTIGATIONS

SUGGESTED SOLUTIONS

DECEMBER 2015 EXAMINATIONS

SOLUTION ONE

Jasper's accounts need to be adjusted in several ways to arrive at the correct taxable profit position for both the period ended 31 December 2014 and the year ended 31 December 2015. The adjustments required are summarised below. As a result of the required adjustments rather than a trading loss arising for the period ended 31 December 2014 a taxable profit of K192,500 has arisen with a taxable profit of K453,500 for the year ended 31 December 2015.

The computation of corrected taxable business profits is as follows:

Jasper Kondolo

Computation of taxable business profits

	Note	Period ended 31 December 2014	Year ended 31 December 2015
		K	K
Net (loss)/ profit as per accounts		(28,000)	198,000
Rent deposit	1	20,000	
Inventory adjustment	2	40,000	20,000
Goods taken for personal use	3		125,000
Capital expenditure	4	90,000	
Repairs	5	20,000	
Private use	6	4,000	4,000
Drawings	7	60,000	120,000
Wife's salary	7	12,000	12,000
Capital allowances	8	(25,500)	(25,500)
Taxable profit		192,500	453,500

Notes

(1) For tax purposes accounts generally need to be prepared which comply with normally accepted accounting principles. The matching concept states that revenues need to be matched with their associated costs as far as possible and be dealt with in the accounting period to which they relate. As a consequence the cost of unsold inventory needs to be adjusted for by carrying these costs forward to match against future sales revenues when this inventory is sold. If this was not the case a taxpayer would be able to reduce his taxable profits to nil by spending all his sales receipts on the purchase of new stock.

(2) As explained according to the matching concept above, the initial outlay for the returnable rent deposit needs to be matched with a corresponding debtor relating to its recoverability at the expiry of the lease. There is therefore a need to add back this amount to the current profit.

(3) If an item of trading inventory is disposed of otherwise than in the ordinary course of the taxpayer's trade case law dictates that it must be brought into account as a trading receipt

at its market value at the date of disposal. Thus the retail value of the inventory consumed privately (both on your house refurbishment and for the additional plumbing work undertaken) needs to be brought into account. An adjustment of K125,000 (K70,000 + K55,000) is therefore required. The retail value of the materials used for the plumbing work will, however, be a deductible cost in arriving at the profits for that business.

(4) Capital expenditure is not allowable in calculating taxable profits. A payment is generally regarded as being capital in nature if made to acquire an asset capable of having an enduring benefit to the trade (usually at least two years). The cost of the van K60,000, shop fittings K24,000 and computer K6,000, adding up to K90,000 are therefore capital in nature and not deductible.

(5) The cost incurred on initial repairs before an asset can be brought into trade use can be problematic. Case law provides some guidance. If, the asset can be brought into immediate trade use, the repairs relate to rectifying normal wear and tear due to use by the previous owner and the purchase price is not reduced to reflect the state of disrepair, then the repair cost is generally allowable. In this case, because the repair work was required to make the van useable and was presumably reflected in the purchase price it is likely that the repair costs will be treated as being capital in nature and therefore disallowable.

(6) Expenditure must be incurred wholly and exclusively for business purposes to be tax deductible. If an expense is incurred both for business and non-business reasons ('dual purpose expenditure') it is generally not allowable. However, in the case of vehicle expenses it is possible in practice to split a total expense into qualifying and non-qualifying portions. As a result an adjustment of K4,000 is required for both periods [Period ended 31 December 2014: (K120,000 – K20,000 – K60,000) x 10% and year ended 31 December 2015: K40,000 x 10%]

(7) Appropriations of profits, such as a sole-trader's drawings, are not tax deductible and therefore need to be adjusted. Case law provides that wages paid to connected parties are deductible only to the extent that they represent what would have been payable to third party employees performing the same duties. It is therefore likely that an adjustment of K2,000 per month (K6,000 – K4,000) will be required for the monthly wages paid to your wife.

(8) Whilst the capital expenditure on the van, fittings and computer is not directly deductible in arriving at profits relief is given via the capital allowances code as follows:

Capital allowances computation

	K
Tax year 2014	
Motor Van Wear and tear allowance 25% x (K60,000 + K20,000) x 90%	18,000
Shop fittings Wear and tear allowance 25% x K24,000	6,000
Computer Wear and tear allowance 25% x K6,000	1,500

Total capital allowances	25,500
Tax year 2015	
Motor Van Wear and tear allowance 25% x (K60,000 + K20,000) x 90%	18,000
Shop fittings Wear and tear allowance 25% x K24,000	6,000
Computer Wear and tear allowance 25% x K6,000	1,500
Total capital allowances	25,500

(b) The amounts of income tax that Jasper should have paid for each of the two tax year is as follows:

	Tax year 2014 K	Tax year 2015 K
Taxable profits	192,500	453,500
Income tax on:		
The first K70,800 of taxable income	9,960	9,960
The balance of taxable income		
(K192,500 – K70,800) x 35%	42,595	
(K453,500 – K70,800) x 35%		133,945
Income tax that should have been paid	52,555	143,905

(c) Jasper is exposed to the penalties and interest for late payments of taxes. In addition, he is also exposed to penalties for late filling of returns and for filling incorrect returns.

(i) Penalties for late or underpayments of taxes

As he did not pay provisional income tax for the tax year 2014, he would be charged a penalty of 5% per month or part thereof on all the amounts of provisional income tax relating to the tax year 2014. These penalties would run from the respective due dates to the date when the Jasper would pay the income tax. The income tax of K52,555 for the tax year 2014 would be deemed to be the same as the provisional income tax for this purpose.

In respect of the tax year 2015, Jasper had underpaid the income tax. The penalties for underpayments would be charged at 5% of the tax per month or part thereof and would run from the respective due dates to the date when the taxes would be paid.

(ii) Interest on overdue taxes

In respect of the provisional income tax for the tax year 2014 that Jasper did not pay, there would also be interest on overdue tax running from the respective due dates to the date when the tax would be paid.

Interest would also be chargeable on the underpaid tax for the tax year 2015 running from the respective due dates to the date when the taxes would be paid.

(iii) Late filling of returns

Jasper filed the 2014 return of provisional income late and would be charged a penalty of 1,000 penalty units per month or part thereof running from the due date to the date when filed.

A further penalty would arise in respect of the 2014 self-assessment income tax return that Jasper was required to file by 30 June 2015 but he did not do it. This penalty would also be 1,000 penalty units per month or part thereof and will run from 30 June 2015 to the date of filling.

(iv) Filing incorrect returns

If the incorrect returns are determined to be fraudulent, a fine for submitting fraudulent returns may be charged and/or there may be imprisonment.

SOLUTION TWO

(a) The Six (6) roles of the tax payer's audit programme are as follows:

(1) **Promotion of voluntary compliance**-by reminding the tax payer of the risks of non-compliance and inculcating confidence in the tax payer, serious abuses can be minimized through dissemination of such tax information.

(2) **Detection of non-compliance** by tax payer-significant omissions and understatements can be detected through a tax audit programme.

(3) **Collection of tax information on behalf of the tax payer**: as details are gathered by the use of the audit programme, certain pattern of risk that emerges can be documented and analysed by the tax auditor .In the final end appropriate audit procedures as such as risk based procedures can be designed to deal with tax evasion /avoidance schemes that can prevent such abuses from happening in future.

(4) **Gather intelligent information**-the information on tax evasion and avoidance can be used to come up with counter measures such as strict inspections and anti- tax squads can be set up.

(5) **Educating tax payers**-audits can assist to clarify the application of the law for individual tax payers and to identify improvements required for record keeping and thus may contribute to improved compliance by the tax payers in the future.

(6) **identify areas of the law** that requires clarification-audits may bring to light areas of the tax law that are causing confusion and problems to large numbers

of taxpayers and thus required further efforts by ZRA to clarify and educate the tax payer.

(b) Circumstances in which a tax investigation may be instituted:

A tax investigation may be instituted in the following circumstances:

(1) Where Tax fraud or tax evasion is reported or suspected in connection with a tax payer

(2) Where a business perpetually reports tax losses.

(c) Audit varies in levels of intensity to which they are conducted. The following are various terminologies that have been given to describe different types of audit activity:

(i) Full audits: it entails a comprehensive examination of a tax payer's tax liabilities for a given period. The purpose is to determine the tax liability for a tax return as a whole.

(ii) Limited scope audit (Issue based audit) :
These are specific in nature and mainly done to examine key potential risk areas of non-compliance. In this case, few resources are used as opposed to a full scale audit.

(iii) Single- issue based audit-these are confided to one potential non-compliance that may be apparent from examination of a tax payer's return.

(iv) Deregistration audits-these are usually conducted in an event that the business would like to file for deregistration for VAT. It normally happens when an entiry's turnover falls below the VAT annual registration threshold of K800,000 or the entity no longer makes taxable supplies or the legal status of the business has changed.

(v) Educational audits-the public needs to be sensitized in terms of knowing the importance of paying taxes to the government. It can also be done in an event that ZRA has introduced new tax legislation. An educational visit can be facilitated in order that tax payer know how such legislation will affect them.

(vi) Credibility audits-this a type of audit aimed at checking the correctness of certain claim for VAT refunds as it happened with the mines at the time they were claiming VAT refunds from the ZRA**.**

(d) THE SIX CAUSES OF SANCTIONS FOR NON-COMPLIANCE.

(i) Understating liabilities stemming from unintended errors, ignorance or misinterpreting of fact or law.

(ii) Under estimation of liabilities resulting from deliberate and /fraudulent acts.

(iii) Failure to keep adequate records and books.

(iv) The failure by a tax payer to submit requested information that is relevant to the conduct of audit inquiries.

(v) When a tax payer evades tax , they are then subjected to criminal prosecution which may lead to imprisonment and /or serious fines**.**

(e) KEY PRINCIPLES OF A GOOD TAX AUDIT.

(i) Accurate-the tax auditor needs to interpret fairly the law relating to tax audit in order ascertain the correctness and accuracy of information contained in the records of the tax payer.

(ii) Efficiency-In this particular case the ZRA staff should use few resources but come up with sufficient audit evidence that ultimately help to save meager resources at their disposal.

(iii) Objective- it is important that all decisions that have been made are clearly based on tangible and factual evidence.

(iv) Transparency-ZRA staff needs to have an open discussion with all tax payers in order to hear their side so as to resolve all issues relating to findings of a tax audit.

(v) Fairness-It is important that an audit is technically and professionally correct in accordance with domestic laws and be consistent with prevailing policies and procedures.

SOLUTION THREE

(a) The additional information that would be required and the reasons why it would be required are as follows:

(i) Sales revenue

Additional information would include establishing whether any goods had been taken for personal and family use.

If so, the market value of such goods must be included in sales revenue.

(ii) Inventory

It would be necessary to consider whether any provisions for losses were dealt with in arriving at the inventory values.

Such provisions are of a general nature and not allowed for taxation purposes. Any increase would be disallowed and any increase deducted from the net profit.

(iii) Salaries

It would necessary to establish whether there were any salaries paid to Mwansa and to family members.

Payments to Mwansa are appropriations of profits and should be disallowed while payments to family members may be disallowed to the extent that they were not wholly and exclusively incurred for business purposes.

(iv) Repairs and renewals

It would be necessary to establish whether there was any capital expenditure included.

Any capital expenditure would be disallowed.

(v) Rent and rates, light and heat, professional fees, subscriptions and donations, motor vehicle running costs

It would be necessary to establish whether there were private elements in each of the above expenditure.

Any private elements would be disallowed for taxation purposes.

(vi) Bad debts

It would necessary to establish whether there were any general provisions, specific provisions and loans written off.
Only specific provisions are tax deductible. General provisions and any loans would be disallowed.

(vii) Interest payable

It would be necessary to establish whether the loan was taken to enable Mwansa meet capital expenditure.

If so, the loan interest would be treated as capital expenditure and therefore disallowed.

(viii) General expenses

It would be necessary to establish whether these are of a revenue nature incurred wholly and exclusively for business purposes or they are capital in nature.

They would only be deductible if they were revenue in nature and incurred wholly and exclusively for business purposes and they were not of a capital nature.

(ix) Subscriptions and donations

It would be necessary to establish whether donations were paid to an approved institution/charity.

Payments would only be tax deductible if they were made to an approved institution/charity and Mwansa did not receive any consideration from the institution.

(b) It may be difficult to make income tax assessments for sole traders due to lack of regulations compelling sole traders to maintain proper accounting records and to prepare annual financial statements which shall be audited. This means that sole traders may not maintain any accounting records at all. In other cases, there would be single entry operated which would make it difficult to determine the profits correctly.

This means that income tax assessments for incorporated businesses may be determined more fairly because companies are required by the Companies legislation to maintain proper accounting records from which annual financial statements must be produced. These annual financial statements are subjected to an audit, which adds

some credibility to them. However, there may still be instances of estimates being made because the accounting records may not be referred to in full when computing taxable profits.

(c) The amount of tax computed should appear in the financial statements, as part of the expenses in the statement of profit or loss and as part of the liabilities in the statement of financial position. These financial statements would show a true and fair view if the amount of taxation computed is correct. The auditor would therefore have a responsibility to verify the tax computation and request any adjustments to be made in the event that some errors are discovered. Verifying the taxation computation would not amount to offering tax consultancy by the auditor.

SOLUTION FOUR

(a)

i) The first consequence of interconnections charges on VAT liability is the fact that this can make the tariffs expensive, consequently it can lead to increase in VAT and eventually tax evasion and avoidance schemes can escalate. While most of telecommunication is in the informal sector, it is important that government regulates this in order to collect tax revenues from these sectors.

ii) The second consequence: If the import VAT and import duties increased, it can result in the importation of cheap handsets and other telecommunication hardware that are of poor standards.

iii) The shifting of business from informal sector of mobile communications to formal sector can result into job losses to the informal sector. Furthermore the cost of collecting VAT will inevitably increase due to administrative costs**.**

(b) (i) **Tax treatment of Discount to Air time dealers**

A discount is deduction from the sales made to a customer by airtime manufacturer according to some form of agreement. Therefore it will be deducted from the sale and it will not form part and parcel of the sale.

(ii) Tax treatment of Discounts to subscribers:

Similarly, a discount given to a subscriber will reduce the cost of his purchase when submitting the tax returns to the Zambia Revenue Authority.

(iii) Tax treatment of Network Switch Expenditure:

Network switch expenditure will be treated as part of a cost of making an outward bound telephone call when ascertaining the cost of accessing telephone services. The caller will be billed as such.

(iv) Tax treatment of Roaming charges and Income.

Making a call to someone on a roaming facility entails charging both the person making the call as well as the one retrieving the cost. However the tax treatment of charges will be determined by establishing where the income which arises from this service facility is recorded or accrued. When the roaming charges are receivable by a company resident here in Zambia, then that income will be subjected to the Zambian laws regarding VAT and income tax. Otherwise they will not be chargeable**.**

(c) Classification of lease agreement

Operating lease

An operating lease is similar to rentals agreement on real property where the lease has the right to use the asset in return for monthly lease payments over the lease term. However the legal title of the assets remains with the lessor. The lessor is entitled to claim capital allowances on the assets. The lessor is also responsible for maintenance and insurance of the asset and those expenses are generally tax deductible. Lease rentals, which include both the capital and interest portions, are recorded as the lessor's gross income.

Finance Lease.

Under a finance lease, it is never intended that the legal ownership of the asset will pass to the lessee. It is basically an agreement that allows the legal ownership of the leased asset to be transferred from the lessor to the lessee on full payment of all of the lease payments. Usually the effective ownership of the leased asset is given to the lease e in anticipation of the transfer of the legal ownership, e.g., hire purchase**.**

(d) (i) **Converted exchange differences:**

An exchange difference is defined as the difference resulting from translating a given number of units of one currency into another at different rates. If an entity deals in foreign currency transactions, it will have to translate its financial statement and the foreign exchange market is volatile.

(ii) **Foreign exchange earnings:**
These are proceeds from the exports of goods and services of a country and the returns from its foreign investments, denominated in convertible currencies. These are profits made from selling goods and services made in a global market. Such earning come in the currency of the country where the products or services are sold, so they have to be exchanged in order to be calculated.

END OF SOLUTIONS