Tax Professional

Knowledge Competency Assessment

November 2014

Paper 1: Solution

South African
Institute of
Tax Professionals

Suggested Solution

Question	Topic	Marks
1	General Income Tax Principles	40
2	Company Tax Advisory	40
3	Company Tax Calculation	40
4	Analysis of Financial Statement	40

Total marks: 160

The marks specified are an indication of the expected length and detail of your response.

Question 1 — 40 Marks

Part A — 10 Marks

Steve McGarret is a South African resident for the whole of the 2015 year of assessment.	(1)	
He is ordinarily resident in Pretoria, because:	(1)	
• He always returns from his wanderings abroad (Australia for work) to South Africa;	(1)	Max: 3
• His normal lifestyle is in South Africa;	(1)	
• He works at a Financial Advisory Firm in Pretoria;	(1)	
• He lives with his sister in a security complex in Centurion / family life is in South Africa;	(1)	
Case law in support of answer		
Candidate must apply information in scenario to principles to obtain marks		
Levene	(1)	Max: 4
Ratio decidendi	(1)	
Cohen	(1)	
Ratio decidendi	(1)	
Kuttel	(1)	
Ratio decidendi	(1)	
Communication skills – logic and argumentation	(1)	
Available marks	10	
Max	10	

PART B 20 Marks

The issue that needs to be addressed by the Candidate is whether the amount from the disposal of the block of flats is income or capital in nature.

Capital receipts are a result from the disposal of a capital asset acquired as an investment, whilst receipts of an income nature are the result of a scheme of profitmaking. (1)

Elandsheuwel Farming-case (1)

Whether Jenny Fuller keeps the flats as an income or capital asset depends on her intention. (1)

Stott-case (1)

Jenny's intention with the acquisition is what she says it is (her ipse dixit) (1)

This is however not decisive. (1)

The courts will also consider the following factors when they determine Jenny's intention

NB! Candidates must apply facts in scenario to the factors highlighted

- The period which the asset was owned – Jenny owns the flats for 10 years; (1)
- The frequency of property transactions – Jenny does not acquire and dispose of fixed property on a frequent basis; (1)
- The flow of income – Jenny has generated rental (lease) income for the past 10 years; (1)
- Jenny's occupation is that of a physiotherapist –she is not a property-dealer / developer; (1)
- The reason for her sale – Jenny wishes to emigrate to Canada; (1)
- Other valid factors… (accounting, behaviour with disposal etc.) (1)

The indication from the abovementioned factors is that Jenny's initial (original) intention is of a capital nature. (1)

Max: 4

The courts have confirmed that each person is entitled to use is capital assets to his best advantage (Stott case – award mark here if not awarded earlier). (1)

The mere decision to sell does not necessarily change Jenny's intention.	(1)
John Bell-case	(1)
A change in intention occurs when Jenny does something more than to just realise her assets to her best advantage – Jenny's actions should therefore transform the nature of the asset to that of trading stock.	(1)
Jenny must cross the so-called "Rubicon" and embark on a trade of property dealing.	(1)
Natal Estates-case.	(1)
Conclusion (depending on the merit of Candidate's argument):	
If the property is sold as a single unit, there is no indication that there was a change in intention, resulting in the amount being of a capital nature and not being included in gross income.	(1)
If the R750 000 is spent, the character of the transaction is changed to realise a bigger profit and can it be seen as a change in intention – the amount is therefore not of a capital nature (therefore income in nature) and consequently not included in gross income.	(1)
Communication skills – presentation and layout	(1)
Available	21
Max	20

Part C 10 Marks

Expenses will qualify for deduction under the general deduction formula if they meet the positive requirement of s 11(a) AND the deduction is not specifically prohibited by any of the negative provisions of s 23.	(1)
In evaluating the deductibility of home office expenditure, the provisions of s 23(*b*) and s 23(*m*) must be considered.	(1)
<u>Determine whether section 23(m) applies:</u>	
Section 23(*m*) determines that an individual may not deduct any section 11 – expenditure, losses or allowances which are connected to the rendering of any service to an employer or which relates to any office held for which	(1)

remuneration is received, ***<u>except the deductions allowed in section 23(m)(i) – (iv).</u>***

The provision could potentially apply as Tony Stark is in receipt of remuneration. The definition of "remuneration" in para 1 of the Fourth Schedule includes salary and commission. (1)

The section 23(*m*) prohibition does not apply if Tony Stark is an agent or representative who receives > 50% of his remuneration from commission.

Percentage of total income earned from commission = R70 000 / R120 000 = 58,3%. (1)

As Tony Stark earns more than 50% of his income from commission the section 23(*m*) prohibition is not applicable. (1)

<u>Determine whether section 23(b) applies:</u> (1)

Section 23(*b*) determines that expenditure incurred in respect of a part of a residence which is used for trade purposes, can only be deducted if:

- The part is specifically equipped and fitted for the trade; and
- The part is frequently and exclusively used for the trade; and
- The employee earns his income mainly from commission and carries out his duties mainly (> 50%) in a place other than in an office provided to him by his employer OR:
- Duties are performed mainly from the study (s 23(*b*)(ii)).
- Tony Stark's study is *specifically equipped for the trade;* (1)
- The study *is frequently and exclusively used for trade purposes; and* (1)
- Tony carries on his duties mainly [70%] from a place other than an office provided to him by his employer. (1)

Tony Stark therefore meets the requirements of section 23(*b*) and his home office expenses are deductible. (1)

IF the expenditure meet all the requirements of s 11(a) or other deduction provisions, eg s 11(e).

Communication skills – logic and argumentation (1)

Available	12
Max	10

Question 2

Part A 10 Marks

Sole proprietorship

Advantages		
• Simple to establish and operate;	(1)	Max: 3
• Owner is free to make decisions;	(1)	
• Minimum of legal requirements;	(1)	
• Owner receives all the profits;	(1)	
• Easy to discontinue the business;	(1)	
• Any other valid statement.	(1)	

Disadvantages		
• Unlimited liability of the owner (or: owner is legally liable for all the debts of the business);	(1)	Max: 2
• Limited ability to raise capital;	(1)	
• Limited skills;	(1)	
• Any other valid statement.	(1)	

Private company

Advantages		
• Life of the business is perpetual (or: company continues uninterrupted as shareholders change);	(1)	Max: 3
• Shareholders have limited liability (they generally are not responsible for the liabilities of the company). Note: although certain tax liabilities exist, students were instructed not to address tax-related concerns;	(1)	
• Transfer of ownership is easy;	(1)	
• Easier to raise capital and to expand;	(1)	
• Efficiency of management is maintained;	(1)	
• Adaptable to both small and medium to large business;	(1)	
• Any other valid statement.	(1)	

Disadvantages

- Subject to many legal requirements; (1)
- More difficult and expensive to establish and operate than sole proprietor; (1)
- Personal liability of directors (imposed by the Companies Act); (1)
- Any other valid statement. (1)

Max: 2

Available	21
Max	10

PART B — 7 Marks

Refer to requirements of s 12E

The student must apply the requirements of s 12E to the facts of the scenario. Marks to be awarded for applying the provisions to the scenario, NOT for restating the legislation

Only a close corporation or private company as defined in s 1 of the Companies Act will qualify:

- Yes: William wants to establish a private company. Note: this will have to be a private company as defined in s 1 of the Companies Act. (1)

The gross income may not exceed R20 million per annum

- Yes: The gross income is only R934 000 (R910 000 + R14 000) (1)

The shareholders must be natural persons

- Yes: William will be the only shareholder (1)

The shareholders may not have other interests other than in permitted investments, for example listed shares or collective investment schemes.

- Yes: The only other shares that William owns are 1000 shares in Barloworld Limited, which is a listed company and therefore an allowable investment. (1)

Not more than 20% of the receipts and accruals may consist of investment income or from rendering personal services.

- Yes: William's investment income constitutes only 2.6% (R24 000/R934 000). (1)

The company must not be a personal service provider

- ‘Personal service provider’ is defined in para 1 of the Fourth Schedule
- Yes: as the company’s business is buying and selling books and it has a variety of customers, it will not be a ‘personal service provider’ (1)

Conclusion: the company would qualify as a small business corporation (1)

Available	7
Max	7

PART C 15 Marks

Alternative 1

Marking comment: If students only discussed the tax positions without showing calculations, marks can be awarded for discussing:

Sole proprietor	
• Normal tax rates applicable to individuals should be applied.	(1)
• Individual entitled to interest exemption (section 10(1)(*i*))	(1)
• Individual entitled to primary rebate	(1)
Micro business	
• Only cash receipts are taken into account in determining the amount subject to tax.	(1)
• No exemptions, deductions or rebates.	(1)
• Special tax rates apply to micro business.	(1)
• Dividends tax should be considered.	(1)
Small business corporation	
• Special tax rates apply to micro business.	(1)
• SBC not entitles to deductions and rebates applicable to individuals	(1)
• Accelerated capital allowance available.	(1)
• Dividends tax should be considered.	(1)
Total tax payable by micro business and SBC: Normal tax + dividends tax	(1)
Discussion indicating evaluation / comparison	2 (MW)

Valid conclusion 1 (MW)

Available	15
Max	15

Alternative 2

(i) Sole proprietor	R	Mark
Turnover **Gross income: taxed at the earlier of receipt or accrual, thus includes credit sales*	910 000	(½)
Interest	24 000	(½)
Gross income	934 000	
Less: interest exemption	(23 800)	(½)
Income	910 200	
Less: general deductions ~ cost of sales ~ operating expenditure ~ rental expense	 (437 000) (68 000) (152 000)	Max 1 [-½ for each error]
Taxable income	253 200	
Tax per individual's 2015 tax table = (R253 200 – R174 550) x 25% + R31 419	51 082	1m/e
Less: Primary rebate *NB: Mark not awarded if s6A rebate was also claimed.*	(12 726)	(½)
Normal tax liability	38 356	
Available		4
Max		4

Marking commentary

- *If candidate did not calculate taxable income, but merely used the 'profit before tax' of R277 000 automatically as taxable income: Only award 2 out of 4½ if student just wrote 'R277 000'.*
- *There is no s 6A medical scheme fees rebate, as no information was provided as to whether Mr Wordsworth is a member of a medical aid. The student cannot assume that he was. Thus: if student claimed a secondary rebate and/or the s 6A rebate, no mark is awarded for the primary rebate.*

(ii) Small business corporation	R	Mark
Profit before tax (See Note A)	277 000	(½)
No accounting or other tax adjustments (interest exemption only for natural persons) (See Note A)	0	(½)
Taxable income	277 000	
Note A: If any adjustments were made or exemptions accounted for: *No marks awarded*		
Tax per 2015 small business corporation tax table = (R277 000 – R70 700) x 7%	14 441	(1m/e)
Primary Rebate claimed: Minus 1		(1)
Profit after tax	262 559	(1)
Dividends tax at 15% on R262 559 - the shareholder is liable for this tax	39 384	(1)
Total tax paid by SBC + shareholder	53 825	(1)
Available		5
Max		5

(iii) Micro business company	R	Mark
Only cash receipts are taken into account. No exemptions, deductions or rebates. For a company 100% of investment income (excluding dividends) is included.		
Turnover – only cash	900 000	(½)
Interest	24 000	(½)
Interest exemption included: Minus 1		(1)
Taxable turnover	924 000	
Tax per 2015 micro business tax table = (R924 000 – R750 000) x 6% + R15 500	25 940	(1m/e)
Primary Rebate claimed: Minus 1		(1)
Turnover tax due to SARS	25 940	
Net profit before tax	277 000	
Tax as calculated above	25 940	
Net profit after tax – available to pay as a dividend	251 060	(1)

Dividend tax: first R200 000 is exempt, therefore 15% x R51 060	7 659	(1)
Total turnover tax plus dividend tax	33 599	(1)
Available		5
Max		5

Marking commentary

- *No marks if student merely used the 'profit before tax' of R277 000 as taxable turnover.*

Conclusion	Marks
Option (iii) Micro business results in lowest total tax liability (income tax/turnover tax plus dividend tax)	(1 m/e)
Available	1
Max	1

PART D 8 Marks

Note*: All references are to the TAA. Students were instructed to discuss the personal liability in terms of the TAA, not in terms of the Companies Act.*

The representative taxpayer is the person responsible for paying the tax liability of the company, in this case the bookkeeper [s 153]. (1)

The representative taxpayer is personally liable for tax payable if, while it remains unpaid, he [s 154] (1)

- Alienates, charges or disposes of amounts in respect of which the tax is chargeable or (½)
- Disposes of the moneys which are in his possession, if the tax could legally have been paid from these moneys. (½)

A 'responsible third party' is a person who becomes otherwise liable for the tax liability of the company (other than the representative taxpayer) [s 158]. (1)

Such person becomes personally liable for the tax debt of another under conditions set out below.

A person is personally liable for outstanding tax debt of the company to the extent that his negligence (or fraud) resulted in the failure to pay the tax debt to SARS [s 180] AND (1)

- The person must also control or must be regularly involved in the management of the overall financial affairs of the company and (½)
- A senior SARS official is satisfied that the person is/was negligent or fraudulent. (½)

Conclusion: (1)

- The bookkeeper did not alienate or dispose of the money earmarked for the employees' tax debt (1)
- The bookkeeper (as representative taxpayer) is not personally liable. (1)
- Mr Wordsworth controls the company as he is the sole shareholder (OR is regularly involved in the management of the financial affairs, by signing off on all payments) (1)
- If a senior SARS official concludes that he was negligent (if not fraudulent), which is very likely, Mr Wordsworth will be held personally liable OR Mr Wordsworth instructed that the employees' tax not be paid and his action are indicative of negligence/fraud and he is therefore personally liable.

Available	10
Max	8

QUESTION 3 40 Marks

PART A 32 Marks

Item / Calculation	Amount	
Manufacturing building (factory) erected R14 250 x 9 months [1] = R128 250	(128 250)	(1)
Personnel agency: Sales representatives (operational expense) Section 11(a) [½] Deduction = (10 sales reps [½] x R10 000 per person [½] x 11 months [½]) = R1 100 000 This represents a pre-paid expense: 2014 yoa: R1 100 000 x 2/11 = R200 000 [1] 2015 yoa: R1 100 000 x 9/11 = R900 000 [1] The services are rendered more than 6 months after year-end. [1] The pre-paid expense of R900 000 together with the prepaid expense of R15 840 relating to the milk purchases exceeds R100 000 [1] in terms of s 23H(bb). *Mark only awarded if the R100 000 limitation was applied to the total pre-paid expenses.* As a result, section 23H [½] limitation applies. Thus, only R200 000 can be deducted in the 2014 yoa. [1] OR: Mark also awarded if only R200 000 deducted in calculation. The remaining R900 000 will be deductible during the 2015 year of assessment.	(R200 000) -	(7½)
Milk purchased		

Trading stock is defined in section 1 as follows:

"Anything ...acquired by a taxpayer for the purpose of manufacture..."

As a result, 80% of the milk purchased qualifies as trading stock.

The milk purchased is a pre-paid expense, but section 23H is not applicable to trading stock.

Section 11(a)
(9 300 litre x R8 per litre) x 80% = R59 520

Section 23F(1)
Expense incurred during a yoa to acquire trading stock that was not disposed of during that yoa, nor held at the end of that yoa, is not deductible in terms of section 11(a).

Allowed section 11(a) deduction:
R59 520 x [(1300 + 1 400)/9 300] = R17 280 OR
((1 300 + 1 400) x R8 p/l) [1] x 80% [1] = R17 280 (R17 280) (2)

S 11(a) deduction prohibited by s 23F(1):

R59 520 – R17 280 = R42 240 OR -

(9 300 – 1 300 – 1 400) x R8 p/l x 80% = R42 240

Plus: Closing stock

Section 22(1) R2 688

(1 400 litres x R8 p/l) [1] x 80% [1] x 30% [1] = R2 688

(3)

The milk on hand at the laboratory do not qualify as trading stock because it is used for research and qualifies as operational expenditure. -

The remaining 20% of the milk purchased that is used for the research, qualifies as operational expenditure in terms of:

Section 11D(1). (3)

Deduction

= (9 300 l x R8 p/l [1] x 20%) [1] x 150% [1]

= R22 320 (R6 480)

The milk (goods) are supplied within 6 months after year-end, but in terms of the provision to s 23H(aa) the 6-month rule does not apply to s 11D(1) expenditure.

Section 23H(bb): Aggregate pre-paid expenses exceed R100 000 (see comment under salaries paid to sales representatives above)

As a result, the s 23H limitation does apply.

<u>This calculation does not need to be performed, only for completeness:</u>

The pre-paid expense comprise the following:

2014 yoa: (1 300 + 1 400) x R8 p/l x 20% x 150% = R6 480

2015 yoa: (9 300 – 1 300 – 1 400) x R8 p/l x 20% x 150%

= R15 840

Wear-and-tear on milk heating machine [s 12C]

R210 000 x [1] x 20% [1] = R42 000 (R42 000) (2)

Recoupment [s 8(4)(a)]

Proceeds ltd to cost

R233 700 ltd to R210 000 = R210 000 [1] (1)

Less: Tax Value (TV)

Cost price	R210 000
Less: Wear-and-tear	
2013: R210 000 x 20%	(R 42 000)
2014: R210 000 x 20%	<u>(R 42 000)</u>
	R126 000 [1]

Thus: R210 000 – R126 000 = R84 000 R84 000 (1)

Tax alternatives for the leasehold improvements:

Alternative 1:

Combination of section 11(g) and section 13(1)

Section 11(g):

R592 800 [1] ÷ [(12 years x 12 months) - 2 months)] (142) [1] x 7 months [1] (1 Feb 2014 – 31 Aug 2014)

= R29 223

Section 13(1):

(R776 639 – R592 800) [1WM] x 5% [1] = R9 192

Total deduction = R29 223 + R9 192 = R38 415	(R38 415)	(5)

Alternative 2:

Section 11(g):

R592 800 [1] ÷ [(15 years x 12 months) - 2 months)] (178) [1] x 7 months [1] (1 Feb 2014 – 31 Aug 2014)

= R476

Section 13(1):

(R776 639 – R592 800) [1WM] x 5% [1] = R9 192

Total deduction = R476 + R9 192 = R9 668

Deemed interest incurred [s 24J]		
Accrual period 1 (1 February 2014 to 31 January 2015):	(R43 714)	(2)
R681 263 x 11% [1] x 7/12 [1] = R43 714		
Taxable capital gain [s 26A]		
- Refer separate CGT calculation	R9 124	
Total effect on taxable income	(R337 577)	

CAPITAL GAINS TAX	AMOUNT	
Proceeds less recoupment		
R233 700 [1] – R84 000 [½WM]		
= R149 700	R149 700	(1½)
Less: base cost		1WM

(R210 000 – R42 000 – R42 000) = R126 000	(R126 000)	
Capital gain	R23 700	
Plus: capital loss brought forward from 2013	(R10 000)	(1)
Net capital gain	R13 700	
Par 10 inclusion rate	X 66,6%	(½)
Taxable capital gain	R9 124	
Communication skills – presentation and layout		(1)
	Available	32.5
	Max	32

PART B 4 Marks

Eastvale Trust:			(1)
Amount	(R0,33 x 20 000)	R6 600	(1)
Contributed tax capital apportioned	(R45 000 x 3%)	(R1 350)	
Dividend		R5 250	(1)
STC-credit apportioned (3% x R10 000)		(R 300)	
Amount subject to dividend tax		R4 950	
Dividend tax at 15% [1mf] = R743			[1mf]
		Available	4
		Max	4

PART C 4 Marks

Available 4

Payment date of dividend = 30 June 2014. [1]
Reason: Earlier of actually paid or payable [½], last date of registration [½] is the date payable and this is before actually paid.
Date of payment to SARS = 31 July 2014. [1]
Reason: Pay at end of the month which follows after the month in which dividend is paid. [1] [4]

Max	4

Question 4 — 40 Marks

Part A — 13 Marks

Profit before tax 4,290,000

Revenue	Sales revenue is taxable ('gross income definition' s 1)	(½)	-	(½)
Cost of sales	Cost of sales effectively tax deductible.		-	
	Opening stock is deductible (s22), closing stock is added to income (s22)	(½)	-	(½)
	and purchases are deductible (s11(a))	(½)	-	(½)
Dividend income	Exempt from normal tax as Fleming owns more than 10% of the shares (s10B(2)(a))	(½)	-1,400,000	(½)
Depreciation expense	Depreciation is not deductible	(½)	1,000,000	(½)
Capital allowances	Deductible		-1,200,000	(1)
Employee cost	Salaries: Deductible in terms of s11(a)	(½)		(½)
	The bonus constitutes "variable remuneration" as contemplated in s7B. It will only be deductible once paid in cash (subsequent tax year)	(½)	500,000	(½)
Sundry expenses	Restraint of trade payment to a company is not deductible under s11(cA): the deduction is prohibited by s23(l).	(½0	100,000	(½)
	Traffic fines paid are not deductible (unlawful expenditure s23(o))	(½)	50,000	(½)
	SARS penalty is not deductible (s23(d)).	(½)	10,000	(½)
	Fair value adjustment is not deductible (s11(a)) since it is not expenditure actually incurred.	(½)	400,000	(½)
Finance cost	Deductible in terms of s24J	(½)	-	(½)
Taxable income			3,750,000	(½)

Available	13.5
Max	13

Part B 2 Marks

Company tax rate is 28%		
Taxable income =	3,750,000	
Profit before tax =	4,290,000	
Normal tax liability for the year is therefore 28% x R3 750 000 = R1 050 000	1,050,000	(1)
Effective tax rate is therefore R1 050 000/R4 290 000(profit before tax) =	24.48%	(1)
	Available	2
	Max	2

Part C 12 Marks

The indemnity payment of R114 000 in respect of Fleming's car is not a deemed supply in terms of s8(8) as it is a 'motor car' as defined in s1 and no input deduction would have been claimed by Fleming.				(1)
Dr	VAT Control	R14,000		(1)
Cr	Motor Car		R14,000	(1)
Reversal of the deemed output tax incorrectly raised on the indemnity payment received				(1)
The indemnity payment of R250 000 made by Delta Insurance in respect of the third party's car is a deemed supply (s(8)(8)) and should be recorded as follows:				(1)
Dr	Motor Vehicle expenses	R30,702		(1)
Cr	VAT control		R30,702	(1)
Deemed output tax payable on the indemnity payment to a third party in terms of insurance contract				(1)
R250 000 x 14/114 = 30,702				(1)
The additional settlement amount of R20 000 paid to the third party does not constitute a taxable supply.				(1)
No input tax deduction is therefore available.				(1)
Dr	Motor car expenses	R2,456		(1)
Cr	VAT control account		R2,456	(1)
Reversal of input tax incorrectly claimed on payment to third party.				(1)
			Available	13
			Max	12

Part D 13 Marks

1	The company now sells exclusively to Bleuchamp	
	Bleuchamp is a non-resident (resident of Mauritius)	(10
	Bleuchamp is also a connected person	(½)
	Bleuchamp is wholly-owned subsidiary - therefore owns more than 20% and no other majority.	(½)
	The sale of goods to Bleuchamp could therefore be an "affected transaction"	(½)
	and invoke the transfer pricing provisions of section 31	(½)
	if a tax benefit was obtained.	(1)
	The company's GP% declined significantly from 2013 which could be an indication that prices charged are not at arm's length:	(1)
	2014 10m/40m = 25%	(½)
	2013 25m/50m= 50%	(½)
2	Mauritius appears to be a jurisdiction that levies less tax than South Africa (corporate tax rate of only 15%).	(1)
	Fleming is a listed company and therefore in the public eye. There is a further risk of reputation damage if the company is not perceived as paying its fair share of tax through profit shifting.	(1)
3	Fleming (a SA resident) owns 90% of the shares in Andolini.	(½)
	Andolini is a foreign company of which more than 50% of the shares are owned by SA residents.	(1)
	Andolini is therefore a controlled foreign company.	(½)
4	There is a risk that the dividends received was not converted at the spot rate but at the average rate (s25D) (although no effect as dividend likely to be exempt).	(1)
5	The bonus constitutes "variable remuneration" as contemplated in s 7B, which will only be taxed when it is payable (subsequent tax year).	
	There is a risk that the employees' tax may not correctly deal with the timing of the accrual.	(1)

6	SARS penalty: Indication of past non-compliance and possible weakness in control over timing of payments; also increased risk of a SARS audit.	(1)
7	There is a risk that the loan advanced by Bleuchamp also constitutes an affected transaction but was not dealt with in accordance with s31 (transfer pricing/thin capitalisation). Refer to point 1 above.	(1)
8	Any other valid point.	(1)
	Available	16
	Max	13