Tax Professional

Knowledge Competency Assessment

June 2015

Paper 1: Questions

South African Institute of Tax Professionals

Instructions to Candidates

1. This competency assessment paper consists of four questions.

2. Answer each question in a separate answer book.

Question	Topic	Marks	Answer Book
1	General Income Tax Principles	40	Blue
2	Analysis of Financial Statements	40	White
3	VAT and Transfer Duty	40	Pink
4	Company Reorganisation	40	Green

   Total marks: 160

   Time: 4 hours plus ½ hour reading time

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

3. Enter your examination number on the cover of each answer book as well as on all answer sheets.

4. Your name must not appear anywhere in the answer books.

5. Answers may not be written in pencil and correction pens (tipex) may not be used.

6. Answer the questions using effective presentation and pay particular attention to the use of concise language, clarity of explanation and logical argument. Marks will be awarded for these aspects of your response.

7. It is your responsibility to ensure that all answer books are handed in to the invigilator before leaving the examination room, as answer books handed in thereafter will not be marked.

Question 1 40 Marks

You are a senior tax consultant at Contax Inc. Details of two clients included in your portfolio is provided hereafter.

Client 1

Winterfell (Pty) Ltd ('Winterfell') is a resident company which commenced with business during 2009. The company is now considering upgrading their current accounting system to a software system called 'Superfast Accounting Solutions' ('Superfast'), as significant growth in business is expected within the next three years.

Stark Enterprises ('Stark') is an Irish company providing comprehensive outsourcing of Information Technology ('IT') services in terms of monthly renewable agreements. Stark mainly carries on their business activities from the Republic of Ireland ('Ireland') and does not have a permanent establishment in South Africa. Stark provided the following quotation relating to the outsourcing of the IT functions to Winterfell:

QUOTATION

Once-off expenditure	
Installation and configuration of hardware Stark will perform these services at the premises of Winterfell	€3 000
User training Stark will utilise their own expertise in providing the training which will be performed at the premises of Winterfell	€6 000
Customised software programs Stark will program software specifically for Winterfell to serve as an interface between Superfast and the current card access control system at the premises of Winterfell	€1 000

Monthly expenditure	
Lease of hardware - servers, network switches and UPS Stark will ensure that the configuration of the hardware will be compatible with the existing personal computers of Winterfell	€1 800 per month
Network stability management, monitoring and administration Stark will perform these services predominantly by means of their centralised call centre in Ireland. If necessary two employees of Stark, stationed in South Africa, will visit the premises of Winterfell to attend to any queries that could not be resolved telephonically – these services will then be invoiced separately	€900 per month
Monthly financial reporting function Consists of various components - refer to Note 1	€1 000 per month

Note 1:

The monthly financial reporting function will be performed as follows by means of input, processing, output and storage of financial data:

Description	Input	Processing	Output	Storage
Activity	Capturing of financial data	Daily processing and reconciliation of financial data in batches	Monthly management reports and reconciliations	Storage of financial data, reports and reconciliations
Hardware involved	Servers and computers of Winterfell located in South Africa	Servers of Stark located in Ireland	Computers of Winterfell located in South Africa	Servers of Winterfell in South Africa and servers of Stark in Ireland

It is not possible to attribute specific expenditure to each of the components of the financial reporting functions (input, processing, output or storage).

Assume that there is no provision in the Double Taxation Agreement between South Africa and Ireland which affects any of the above transactions.

Client 2

Snow is a company that renders cold storage services. In 2005, Snow received a large sum of money from the sale of one of its cold storage facilities which it used to purchase a block of flats in Johannesburg. The decision was made to diversify Snow's business to provide an additional revenue and cash flow stream from a long-term investment. The flats were acquired in 2005 at a cost of R4 million. Snow has derived rental income from the flats for the past 10 years.

Snow has now decided to sell the block of flats because the company is considering expanding its business to Namibia and requires funding to construct cold storage facilities in Windhoek.

Snow's directors have consulted an estate agent who has advised them that it could sell the property in one of two ways:

1. Snow could sell the entire block of flats as one property in its present condition.
2. Alternatively, Snow could divide the block of flats into sectional title units and sell the flats individually.

The estate agent estimates that the selling price of the block of flats as a single property will be R15 million. He has told Snow's directors that if the company spends R600 000 on upgrading the building and opening a sectional title register it can expect to sell the flats for R15.8 million in total.

Question 1 Required		Marks
1	Client 1 Discuss whether (or not) the amounts provided in the quotation would represent *income from a source in South Africa* for Stark Enterprises. *Support your answer with references to relevant legislation and case law.* *Communication skills – presentation and layout*	18 2
2	Client 2 Discuss in detail whether the *proceeds* from the sale of the property either as a single property or as sectional title units will be of an *income or capital* nature in Snow's hands. *Please ignore Value-Added Tax. Support your answer with references to relevant case law.* *Communication skills – presentation and layout*	18 2
	Total	40

Question 2 40 marks

You are the external tax consultant of SA Generators (Pty) Ltd ('Sagen'). You have been requested to assist with Sagen's normal income tax calculation and submission of the company's IT14 income tax return for the 2015 year of assessment.

Sagen was incorporated in South Africa on 31 December 2014. Sagen imports large industrial emergency power generators for supply to local customers and manufactures portable generators for the local market. Sagen' uses International Financial Reporting Standards ('IFRS') when preparing its financial statements and the financial statements are audited. Sagen is a registered VAT vendor.

As at 31 December 2015, the directors and shareholders of Sagen were as follows:

Name	Country of residence	Number of shares held	Director (yes/no)
Mr John Barnes	RSA	60	Yes
Me Eleanor Fields	RSA	30	No
Osato Engineering Company Ltd	Japan	10	No
Total number of shares issued		100	

John Barnes is the managing director of the company. He owns shares in several other private companies and close corporations incorporated in South Africa.

A cash distribution of R1 000 per share was declared on 31 December 2015 due and payable to all registered shareholders as at 31 December 2015. The distribution was paid on 2 January 2016.

You have been provided with the following extract for the year ended 31 December 2015:

SA GENERATORS (PTY) LTD

DRAFT STATEMENT OF PROFIT / LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2015

	Reference to additional information	2015 R
Revenue	1	49 100 000
Cost of sales	2	(20 000 000)
Gross profit		29 100 000
Depreciation	3	(1 960 000)
Employee cost	4	(6 000 000)
Other operating expenses	5	(2 100 000)
Finance income	6	5 000
Profit before tax		19 045 000

Additional information

1. Revenue consists of the following:

	R
Sales to local retailers	40 000 000
Sales to special customer (refer to 1.1)	9 100 000
Total	49 100 000

1.1 Sagen made a large sale to a local special customer on 31 December 2015, and a sales invoice was issued for R10 000 000 (excluding VAT). The special customer has negotiated to only settle this invoice after 12 months. Since such credit terms are unusually long, IFRS requires Sagen to measure the sale at its present value of R9 100 000.

2. Cost of sales was calculated as follows:

	R
Opening inventory	5 000 000
Purchases: industrial generators imported from Japan (refer to 2.1)	10 000 000
Purchases: raw materials used in the production of portable generators	7 000 000
Closing inventory	(2 000 000)
Total	20 000 000

2.1 All industrial generators are purchased from one of Sagen's shareholders, Osato. The purchases amount includes an order for R2 000 000 (excluding VAT) that was shipped from Japan on 24 December 2015 and arrived in South Africa on 5 January 2016. Since the ordered generators were not on hand on 31 December 2015, they were not included in the inventory count and therefore excluded from the closing inventory amount.

3. Depreciation was calculated as follows:

	R
Computers (refer to 3.1)	10 000
Machinery (refer to 3.2)	750 000
Office building (refer to 3.3)	1 200 000
Total	1 960 000

3.1 Ten laptop computers were purchased on 1 January 2015 for R3 000 each (excluding VAT). It is the entity's accounting policy to depreciate computers over a period of three years using the straight-line method. No residual value is allocated to the computers.

3.2 New and unused machinery, used in the manufacturing of portable generators, was acquired on 1 April 2015 at a total cost of R6 000 000 (excluding VAT). It is Sagen's accounting policy to depreciate machinery over a period of six years using the straight-line method. No residual value is allocated to the machinery.

3.3 A used office building was acquired for R12 000 000 (excluding VAT) on 1 January 2015. It is Sagen's accounting policy to depreciate the building over a period of ten years using the straight-line method. No residual value is allocated to the building.

4. Employee cost consists of the following:

	R
Salaries and wages	2 500 000
Performance bonus: factory manager (refer to 4.1)	500 000
Share-based payment to John Barnes (refer to 4.2)	3 000 000
Total	6 000 000

4.1 The factory manager, Harry Sly, is entitled to a R500 000 performance bonus, provided that that the factory meets a production target of 1 million generators during the year. This target was reached by the end of October 2015. The bonus was paid to Harry during March 2016.

4.2 It was decided to award ten additional shares to Sagen's managing director, John Barnes, on 15 December 2015. The shares had a market value of R3 million on the date of issue. The following entry was recorded for accounting purposes:

Debit/Credit	Account	R
Debit	Share-based payment expense	3 000 000
Credit	Share capital account	3 000 000

5. Other operating expenses consist of:

	R
Factory lease payments	1 200 000
Traffic fines incurred by delivery drivers	100 000
Restraint of trade payment made to rival company	700 000
Interest on late submission of EMP201 employees' tax return	5 000
Interest incurred on loan used to purchase listed shares	15 000
General expenses (tax deductible)	80 000
Total	2 100 000

6. A loan of R1 million was advanced to Ms Eleanor Fields on 1 July 2015. The loan bears interest at 1%.

Question 2 Required		Marks
a	Provide three (3) reasons why Sagen is not a small business corporation as defined in section 12E(1) of the Income Tax Act No. 58 of 1962.	3
b	Calculate the taxable income of Sagen for the 2015 year of assessment. *Start your answer with profit before tax.* *Your calculation should be supported with brief reasons for each item listed in the question (even if it has a nil effect).*	24
c	Discuss all dividends tax consequences evident from the information provided. *Support your answer with calculations and indicate when the amount of dividends tax is payable.*	13
	Total	40

Question 3 40 marks

This question consists of two independent parts.

Part 1

You are a consultant in the indirect tax department of your firm. You have been approached by a new client that is planning to export various candy to Botswana. At the time, you did not have any knowledge of the client or the manner in which his business is conducted.

Part 2

Johnsons Ltd ('Johnsons') is not currently a registered VAT vendor, but will be registered as a VAT vendor by way of voluntary registration in three months' time. Johnsons is currently considering the sale of two properties. The first property is an office unit that is currently leased to Smarted Ltd ('Smarted') for R25 000 per month. According to the lease contract the office unit will be leased to Smarted until 31 December 2019. The lease contract also provides that the monthly lease amount can be increased with VAT, if the leaseholder registers as a VAT vendor.

The second property is a flat that is currently leased to Mary Mwanda for R5 000 per month. Mary uses the flat solely for residential purposes. According to the lease contract the flat will be leased to her until 31 December 2020. The lease contract also provides that the monthly lease amount can be increased with VAT, if the leaseholder registers as a VAT vendor.

Teshiba Ltd ('Teshiba'), a registered VAT vendor is interested in buying both of the properties from Johnsons. Teshiba is however, unsure whether they should wait three months for Johnsons to register for VAT before purchasing the properties.

During negotiations with Johnsons, it was agreed that if they were to buy the properties now (three months before Johnsons register as a VAT vendor), Johnsons will sell the office unit for R4 000 000 and the flat for R1 000 000 to Teshiba. If they were to wait for three months for Johnsons to be registered as a VAT vendor, Johnsons will sell the office unit for R4 050 000 (excluding VAT) and the flat for R1 020 000 (excluding VAT) to Teshiba. Irrespective of the option chosen, Teshiba will pay the full purchase price on the date of sale.

In all instances the lease contracts will be transferred together with the properties. Teshiba will therefore continue to lease out the office unit to Smarted for R25 000 per month (excluding VAT) and the flat to Mary Mwanda for R5 000 per month (excluding VAT) after acquiring the properties.

You may assume the following:

1. *In all instances both parties will agree to any legislative or documentary requirements that would minimise any tax payable;*
2. *The amount of income tax paid by Teshiba on the rental income will be R8 500 for the office unit (for every month's rental) and R1 500 for the flat (for every month's rental);*
3. *Johnsons and Teshiba are not connected persons as defined per the Income Tax Act No. 58 of 1962; and*
4. *Both properties, irrespective of time of sale, are sold at market value.*

Question 3 Required		Marks
1	Provide at least six questions that you would ask the client, and provide a reason after each question why the question is of importance, in determining the potential South African VAT consequences as a result of the exportation of the candy. *Present your answer in table format.*	12
2	Calculate and discuss, with reference to relevant legislation whether (or not): i) Teshiba should purchase the *office unit* now or wait three months until Johnsons is a registered VAT vendor; ii) Teshiba should purchase the *flat* now or wait three months until Johnsons is a registered VAT vendor.	17 11
	Total	40

Question 4 40 marks

Part 1

Avengers Ltd (a JSE listed company) is a share dealer with a 31 July year-end. Avengers had the following transactions during the 2015 year of assessment:

1. Shares in Shield Ltd, a venture capital company (VCC), were sold for R500 000 on 1 September 2014. The shares were bought at a cost price of R400 000 on 1 July 2014 and a VCC investor certificate was received.

2. Shares in Thor Ltd, an unlisted foreign company, were sold for R650 000 on 15 September 2014. The shares were bought five years ago at a cost price of R240 000.

3. 8 000 shares in Hydra Ltd, a listed RSA company, were sold for R32 000 (R4 per share) on 1 October 2014. The shares in Hydra Ltd were bought on:

	R
1 March 2011 (5 000 shares)	10 000
1 May 2012 (2 000 shares)	4 800
1 June 2012 (8 000 shares)	20 800

4. Shares in Sun Ltd (RSA company) were sold on 1 November 2014. The shares were bought in terms of a dividend stripping scheme for R50 000. A dividend of R70 000 was declared out of the available reserves and the remaining shell was sold for R10 000 two months later.

Part 2

Iron Man (Pty) Ltd ('Iron Man') is a South African resident company (situated in Cape Town) which manufactures and sells a variety of energy drinks. The South African Revenue Service ('SARS') deems the manufacturing of energy drinks to be a manufacturing process. The following information applies to Iron Man's financial year ended 31 December 2015:

Investment in The Avengers Plc

Iron Man owns 25% of the voting rights and 45% of the equity shares of The Avengers Plc (an American company) from 1 January 2014. Apart from Iron Man, Tony Stark (a 38-year old South African resident) is the only other South African resident who owns voting rights and equity shares in The Avengers Plc from 1 January 2014. Tony owns 40% of the voting rights and 20% of the equity shares of The Avengers Plc. The remaining voting rights and equity shares are owned by non-residents.

Tony sold his entire investment in The Avengers Plc to Steve Rogers for R975 000 on 1 August 2015. Steve Rogers is an American resident. The Avengers Plc's foreign tax year ends on November of each year. The net income of The Avengers Plc for purposes of section 9D(2) for the following periods, was as follows:

1 December 2014 – 30 November 2015	\$150 000	\$1 = R6,95
1 December 2014 – 31 July 2015	\$123 000	\$1 = R6,75
1 January 2015 – 31 December 2015	\$167 000	\$1 = R6,60
1 January 2015 – 31 July 2015	\$117 000	\$1 = R6,66

Ignore any Double Tax Agreements ('DTA's') which might exist between South Africa and the United States of America. Bear in mind that Iron Man wishes to minimise its normal income tax liability at all times.

Financial instrument

Iron Man acquired a financial instrument with a face value of R500 000 at a discount of R50 000 on 1 June 2015. The instrument has a two-year term and a 4-monthly coupon rate of 4% based on the face value. The 4-monthly yield-to-maturity is 6.04%. Iron Man is not a dealer in financial instruments.

Question 4 Required		Marks
a	Part 1 Calculate the effect of each of the above-mentioned transactions on the taxable income of Avengers Ltd for the 2015 year of assessment.	15
b	Part 2 1. Discuss in detail the gross income implications for Iron Man in respect of its shareholding in The Avengers Plc for the 2015 year of assessment. 2. Calculate and show the effect of the financial instrument on Iron Man's taxable income for the 2015 year of assessment. *Show detailed calculations and round off all amounts to the nearest Rand.* *Communication skills – presentation and layout*	17 7 1
	Total	40