Tax Professional

Knowledge Competency Assessment

June 2014

Paper 2: Question

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	Partnerships' Taxable Income	40	Blue
2	Estate Duty	40	White
3	Individual Tax	40	Pink
4	Various Income Tax Consequences	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

Barry, Robin and Maurice Kgomo (all three brothers and younger than 65 years of age) carry on a manufacturing business as a partnership under the name *BeGe Music*. The partners share equally in all profits and losses of the business. *BeGe Music* manufactures musical instruments. The business was started by their grandfather, Ben Kgomo. Barry, Robin and Maurice originally worked as employees for Ben at a salary of R120 000 per annum before they became partners in March 2010 when Ben retired.

All VAT consequences for the partnership have been correctly determined. The statement of comprehensive income (amounts exclusive of VAT) is provided for the partnership for the year of assessment ended 28 February 2014 is as follows:

	R
Income	
Gross income from trading	2 903 464
Interest received on credit balance of bank account	3 200
Dividends (the partners own 100 000 of the ordinary shares of Night Fever (Pty) Ltd and for which a dividend of R2.60 per share had been declared)	260 000
Expenses	
Salaries and allowances (including payments to partners – see note 1)	(1 156 887)
Drawings (Note 2)	(39 000)
Unemployment insurance fund contributions (UIF) and skill development levies (SDL) in respect of employees' salaries	(36 400)
Contribution to employees' pension fund (the partnership contributes an amount equal to 8% of its employees' salaries to a pension fund on behalf of the employees)	(25 600)

Contribution to partners' pension fund (the partnership contributes an amount equal to 8% of its partners' salaries to a pension fund on behalf of the partners)	(50 400)
Contributions to medical scheme (the partnership contributes R1 000 per month per employee and per partner to a medical aid scheme. The partnership contributed for the full year of assessment in respect of each partner and employee)	(96 000)
Short-term insurance premiums	(68 000)
Life insurance premiums on the lives of partners	(3 600)
Depreciation on office furniture (the office furniture was purchased on 1 March 2010 for R75 000. The office furniture is depreciated over four years for accounting purposes. Binding general ruling No 7 provides for a write-off period of six years on furniture.)	(18 750)
Depreciation on delivery vehicle (the delivery vehicle was purchased on 1 July 2010 for R288 000. The delivery vehicle is depreciated over five years for accounting purposes. Binding general ruling No 7 provides for a write-off period of four years on delivery vehicles)	(57 600)
Depreciation on factory building (note 3)	(Nil)
Depreciation on Machine A (note 4)	(650 000)
Interest paid in respect of partners' capital accounts (see note 1 and 5)	(44 200)
Provision for leave pay (note 6)	(99 500)
Net profit	820 727

Notes:

1. Partnership profits

The partnership agreement makes provision for the following payments to be made each year to the partners:

(a) Salary

•	Barry	R230 000
•	Robin	R200 000.
•	Maurice	R200 000
	Total	R630 000

(b) Interest at 10% on the opening balance of their capital accounts (see note 5 for amounts)

(c) After the deduction of these amounts, the partnership's profit (or loss) is shared equally between the partners.

2. Drawings – Barry Kgomo

During the year of assessment, Barry drew R39 000 out of the partnership's bank account to pay for private expenses.

3. Depreciation on buildings

The current factory building was erected by the partnership at a cost of R6 500 000 and brought into use on 1 June 2012.

4. Depreciation on Machine A

BeGe Music ordered a manufacturing machine (Machine A) from a supplier in France for €250 000 on 1 November 2013 to use in the manufacturing process. Machine A was shipped free-on-board (FOB) on 15 November 2013 and was delivered at *BeGe's* premises on 25 November 2013. The payment for the machine was made to the supplier on 15 November 2013. The import duties of R25 000 were paid on importation. *BeGe Music* had to erect a supporting structure at a total cost of R17 500 to support the machine before it was brought into use on 1 December 2013.

The following exchange rates were applicable:

Date	Spot rate €1 = R
1 November 2013	€1 = R10,75
15 November 2013	€1 = R10,70
25 November 2013	€1 = R10,68
1 December 2013	€1 = R10,60
28 February 2014	€1 = R9,70

5. Interest paid to partners

	R
Barry Kgomo	6 500
Robin Kgomo	4 300
Maurice Kgomo	33 400
	44 200

6. Provision for leave pay

The leave pay provision was increased by R99 500 for the 2014 financial year. As at 28 February 2014 the balance on the leave pay provision amounted to R150 500. Actual leave payments made, were all made on 28 February 2014 and have been expensed directly to salaries.

Additional information relating to Robin Kgomo:

- Robin contributes 8% of his monthly salary from the partnership to the partnership's pension fund in addition to the partnership's contribution.
- He contributes R680 per month to a retirement annuity fund.
- He contributes R850 per month to a medical scheme in addition to the partnership's contribution. Robin is the only dependant on the scheme.
- He received R36 000 net rental income during the 2014 year of assessment.

Assume that the salaries paid to partners and employees qualify as approved remuneration for purposes of s11(*l*).

The cost price of all assets excludes VAT, where applicable.

<table>
<tr><td colspan="2" rowspan="2">Question 1
Required</td><td colspan="2">Marks</td></tr>
<tr><td>Sub-total</td><td>Total</td></tr>
<tr><td>a</td><td>Calculate a partner’s share of the partnership’s taxable income for the year of assessment ended 28 February 2014. Start your answer with the net profit of R820 727 as reflected on the statement of comprehensive income. Each item listed in the statement of comprehensive income must be addressed in your answer with a brief reason for its inclusion, deduction or omission in your answer.</td><td>20</td><td rowspan="3">40</td></tr>
<tr><td>b</td><td>Calculate Robin Kgomo’s taxable income for the year of assessment that ended on 28 February 2014.</td><td>15</td></tr>
<tr><td>c</td><td>Chester Kgomo (Barry, Robin and Maurice’s father) agreed to become a limited partner by contributing a specified amount of capital. The capital will be used to expand the partnership’s business operations. According to the agreement Chester will receive a percentage of the profits, but the losses will be restricted to the amount of capital contributed by him. Please explain to Chester the tax deductibility of an allowance or deduction if a taxpayer is a limited partner.</td><td>5</td></tr>
</table>

Question 2 40 marks

As a registered tax practitioner you regularly provide various tax and administration services relating to deceased estates. Anthony Collins (a landscape designer with ID number 580606 9980 00 4) has been one of your clients for a number of years. Anthony died suddenly at home on 20 January 2014 at the age of 55. He was married out of community of property to his wife, Cynthia (ID number 650302 1122 05 9), with the accrual system applying to their marriage. They were married on 7 December 2011. Both Anthony and Cynthia have always been citizens and residents of South Africa.

Anthony was married before (out of community of property with the accrual system applicable to their marriage), to Anne Collins (ID number 601119 2900 02 1), who died on 1 July 2001. Anthony and Anne had two children born out of their marriage: daughter Amy (32 years old and unmarried at the date of Anthony's death, ID number 810501 4334 08 7) and son Jake (29 years old and unmarried at the date of Anthony's death, ID number 840321 7778 07 5). Anne bequeathed her entire net estate (amounting to R1.3 million) to Anthony.

Anthony is survived by Cynthia, Amy and Jake.

Notes on Anthony's assets and liabilities at the date of his death:

1. Anthony purchased a house in Menlyn, Pretoria at a cost of R4 million on 1 July 2007 and a mortgage loan in favour of APSA Bank was registered over the property. The balance on the mortgage loan owing to APSA Bank was R3 063 276 on 20 January 2014. Since the acquisition of this property Anthony and his family ordinarily resided therein and used it exclusively for domestic purposes. Anthony's children and Cynthia all remained resident in the house after Anthony's death. The fair market value of this property at the date of Anthony's death amounted to R7.1 million.

The fair value of the furniture and personal effects in the residence belonging to Anthony amounted to R799 000 at the date of Anthony's death.

2. Anthony purchased a holiday apartment in Mossel Bay on 17 September 2005 for R2.5 million. At the date of his death it was valued at R4 million.

   You have (correctly) calculated that the taxable income earned by Anthony for the period 1 March 2013 to 20 January 2014 from the letting of this holiday apartment amounted to R25 000. As executor you have rented out the apartment to holiday makers during the month of February 2014 for R20 000. You collected the rent and paid it into the estate's cheque account. You have incurred tax deductible expenses amounting to R17 000 in respect of this property until the date of its sale at auction in February 2014.

3. Anthony owned a Mercedes Benz CLK350 Cabrio vehicle, valued at R299 000 at the date of death. The vehicle was purchased on 1 September 2009 for R450 000. Anthony always used the vehicle for private purposes only.

4. Anthony and Tom Greco formed Landscaping Solutions (Pty) Ltd (*LS*) on 1 March 2005. Each of them made a R325 000 share capital contribution to the company (each acquired 325 of the 650 issued ordinary shares of R1 000 each of the company). The auditors of *LS* placed a value of R7 million on all of the company's shares as at the date of Anthony's death (this takes into account the effect of policy C as discussed in item 2. of *Additional information* below).

   On 31 July 2013 *LS* declared and paid a dividend of R2 500 per share to the two shareholders. The relevant amount of dividend's tax was withheld and paid over by the company.

   Anthony received a monthly cash salary (no fringe benefits) of R55 000 from *LS*, which deducted employees' tax of R16 147 every month. *LS* paid a full month's salary for January 2014

5. Anthony inherited the usufruct over farm land from his late father. Anthony was 45 years old at the time of his father's death and the market value of the farm was R1 600 000 at that time. In terms of his father's will, the bare dominium of the farm was bequeathed to Anthony's son, Jake. The market value of the property was R2 800 000 at the date of Anthony's death.

   Anthony entered into a lease agreement on 31 March 2009 whereby the farm is rented out at R15 000 per month. The agreement is renewable annually and was renewed on 31 March 2013, but cancelled on 31 March 2014. The tenant of this farm always promptly paid the rent on the first of every month into Anthony's bank account. As from 1 February 2014 the rent was paid into the estate's cheque account as per your instructions.

6. Anthony owned 2 000 shares in Solo Ltd., a company listed on the JSE, which were valued at R100 per share on 20 January 2014. Anthony purchased the share in 2009 at R90 per share. You have already determined that Anthony is not a share-dealer.

Testamentary stipulations:

1. The residence in Menlyn is bequeathed to the Collins Family Trust (free of the mortgage loan), with the usufruct of the residence being awarded to the surviving spouse, Cynthia, for the rest of her life. The furniture and personal effects belonging to Anthony are also bequeathed to Cynthia. The Collins Family Trust is an *inter vivos* vesting trust with Anthony, Cynthia, Amy and Jake as capital and income beneficiaries. The trustees of the trust are Anthony, Cynthia, and Anthony's lawyer, Phil Benton.

2. The holiday apartment was to be sold in order to provide cash for the payment of estate liabilities and costs. You sold the property at auction on 22 February 2014 for R4.3 million.

3. The Mercedes Benz motor vehicle is bequeathed to Jake.

4. The shareholding in Landscaping Solutions (Pty) Ltd had to be sold at market value (at the date of Anthony's death) to Tom Greco in terms of a buy-and-sell agreement. R400 000 of the proceeds had to be distributed to Cynthia and R400 000 of the proceeds had to be distributed to the Collins Family Trust. The rest of the proceeds had to be used to pay liabilities in the estate.

5. All the listed shares had to be transferred to Amy. Since this would constitute a considerable amount, the will stipulated that Amy had to pay a bequest price of R100 000 to her brother Jake. Amy refused to accept this condition and repudiated this inheritance.

6. The residue of the estate is bequeathed to Anthony's local church (not a registered Public Benefit Organisation).

Additional information

1. Anthony's life was insured for R2 500 000 and his daughter, Amy, is the beneficiary of this policy (policy A). The proceeds were paid out to her on 6 February 2014. During his lifetime, Anthony paid all of the premiums on this life insurance policy.

2. Tom Greco had taken out policy B on Anthony's life to the value of R4 000 000 in order to enable him to purchase Anthony's share in Landscaping Solutions (Pty) Ltd (see notes on testamentary stipulations above). Tom paid all of the premiums on this policy, amounting to R79 000 (including interest at 6%). The policy paid out to Tom on 4 February 2014.

   During March 2008 Anthony became concerned about the possible detrimental effect his death would have on Landscaping Solutions (Pty) Ltd. At his insistence the company took out life insurance policy C to the value of R1 000 000 on the life of Anthony. Anthony paid half of the monthly insurance premiums in respect of this policy. The total premiums paid in respect of this policy (including interest at 6%) amounted to R36 000.

3. Anthony's funeral expenses amounted to R25 000 and were paid out of the estate (paid to ZZZ Undertakers).

4. At the start of Anthony and Cynthia's marriage on 22 January 2011 their ante-nuptial contract showed that Anthony had a net estate value of R8 659 000 and Cynthia's net estate amounted to R99 000.

   Anthony donated R450 000 to Cynthia on 27 July 2012 after she expressed interest in a very expensive diamond bracelet while on a shopping spree.

   At 20 February 2014 the only assets owned by Cynthia were jewellery items valued at R677 000.

5. Anthony received no income from 1 March 2013 until the date of his death, other than the amounts that are mentioned above. He also did not sell any capital assets during this period.

6. In addition to the prescribed Master's fees and executor's remuneration, you also incurred and paid the following costs relating to the administration of Anthony's estate:

	R
Valuation fees	18 000
Transfer costs	35 000
Advertising costs	350
Auctioneer's commission	155 000
Bank charges on estate cheque account	1 200

7. Anthony made provisional tax payments of R35 000 during the period from 1 March 2013 until the date of death.

Question 2 Required		Marks	
		Sub-total	Total
a	Calculate the normal tax liability of Anthony Collins for the period of assessment ended 20 January 2014	10	40
b	Calculate the estate duty payable in the estate of the late Anthony Collins. *Show all your calculations and round off to the nearest Rand.*	30	

Question 3 40 marks

Antonios and Anzel were divorced on 1 December 2012. Antonios (46 years old) and their 16 year old son, Altus, live in South Africa. Anzel (40 years old) and Lena (Anzel's deceased sister's 10 year old disabled child who was adopted by Anzel on 10 January 2010), live in Greece. Anzel immigrated to Greece on 15 December 2012.

The following information is available in respect of the 2014 year of assessment:

	Note	Antonios	Anzel
		R	R
Salary and lump sum	1	850 000	360 000
Company car	2	?	-
Residential accommodation and holiday accommodation	3	?	?
Medical aid fund contributions	4	14 000	24 000
Medical expenses	4	68 000	60 000
Maintenance received	5	200 000	
Interest received	6		10 000
Dividends received	7	15 000	
Royalties received	8	120 000	80 000
Annuity received	9		80 000

Additional information

1. Antonios's services was terminated by Employer A Ltd on 1 March 2013 due to a general personnel reduction and he received a lump sum amount of R600 000 from Employer A Ltd on 1 March 2013.

   Antonios started working for Employer B Ltd on 1 May 2013 and earns a fixed salary of R25 000 per month.

   Anzel is in the service of the South African Government and is stationed in Greece as a diplomat. She earns a monthly salary of R30 000.

2. Antonios enjoys the right of use of a company car from Employer B with a cost price of R456 000 (VAT included). The company did not take out a maintenance plan in respect of the car. Antonios's accurate logbook (SARS is satisfied) shows that he travelled 14 000km for business purposes and 20 000km in total. Antonios paid all the costs of fuel for private use.

3. Employer B Ltd rented a flat at the sea from company C Ltd at a rate of R100 per person per day for a period of 10 days. B Ltd and C Ltd are managed by the same persons. Antonios and Altus and two of Altus's friends were on holiday together for the 10 days. The flat is normally rented out by C Ltd at a rate of R200 per person per day.

   Anzel attended a training program in South Africa from 1 June 2013 to 31 August 2013. Her employer paid R20 000 per month to rent a four-roomed furnished house with electricity. Anzel's remuneration proxy is R250 000.

4. From 1 May 2013 Employer B Ltd made monthly contributions of R1 400 to a medical aid fund for the benefit of Antonios and Altus (his only dependent). The following medical expenses was paid by Antionios but not recovered from the medical aid fund.

	R
Operation for Lena (per agreement with Anel)	50 000
Operation for Altus's eyes	15 000
Non-prescription medication	3 000

Anzel is a member of a medical scheme and she pays the monthly contributions of R2 000 in respect of herself and Lena. Anzel paid the following medical expenses herself (and did not recover it from the medical aid fund):

	R
Operation for her aged mother for who she is liable for family care and support	40 000
Wheelchair for Lena	20 000

5. Anzel's Pension Fund reduced her minimum individual reserve on 1 June 2013 in terms of a maintenance order. An amount of R200 000 had to be paid to Antonios in terms of the maintenance order. The Pension Fund deducted employees' tax on the payment to Antonios at 25% in terms of the directive from the SARS, reduced Anzel's minimum individual reserve with both the amounts and paid the employees' tax over to SARS.

6. Antonios received interest of R30 000 from a RSA bank and interest of R15 000 from a bank in France.

   Lena received interest of R10 000 on a RSA investment. This investment was made by her uncle Koos. Anzel made a similar investment in Greece in the name of Koos's wife.

7. Antonios bought 5% of the shares in ABC Ltd in his name and 10% of the shares in ABC Ltd in Altus's name. Antonios received dividends of R15 000 and Altus received dividends of R30 000. ABC Ltd is a French company.

8. Both Antionios and Anzel created patents and incurred expenses in the creation thereof.

		Gross royalty received R	Expenses incurred R
Antonios:	Received from a non-resident for use outside the RSA	120 000	40 000
Anzel:	Received from a non-resident for use in the RSA	80 000	25 000

9. On 1 July 2013 Anzel received an annuity from the RSA trust created by her father. The R80 000 consists of R20 000 RSA dividends and R60 000 RSA interest.

10. Anzel sold an immovable property situated in the RSA for R3 500 000 on 1 April 2013. The base cost was R1 000 000. The property was sold to a resident individual.

11. Anzel made monthly contributions of 8% of her salary to the pension fund in terms of the rules of the fund.

<table>
<tr><td colspan="2" rowspan="2">Question 3
Required</td><td colspan="2">Marks</td></tr>
<tr><td>Sub-total</td><td>Total</td></tr>
<tr><td>a</td><td>Explain the tax implications of the lump sum received by Antonios from Employer A. Supply short reasons and refer to the applicable sections of the Income Tax Act.</td><td>3</td><td rowspan="3">40</td></tr>
<tr><td>b</td><td>Calculate the normal tax liability of Antonios (excluding the lump sum) and calculate the normal tax payable by or to Anzel for the year of assessment ended 28 February 2014. Assume that the total employees’ tax deducted by Anzel’s employer amounted to R126 047.</td><td>36</td></tr>
<tr><td>c</td><td>Identify Anzel’s various employers, with reference to the income stream making such entity and employer.

Show all your calculations in respect of all inclusions, exemptions, deductions and withholding tax.

Ignore provisional tax.
Clearly state the dates on which any withholding tax must be paid over to SARS.</td><td>1</td></tr>
</table>

Question 4 40 marks

Top Steel Ltd ('*Top Steel*') is in the steel manufacturing business; it manufactures flat steel that is mostly used by the motor industry. *Top Steel* owns 100% of the shares in each of 5 subsidiaries that supplies iron ore to *Top Steel* and other steel manufacturers. The 5 subsidiaries are located in South Africa and are residents.

Top Steel is listed on the Johannesburg Stock Exchange and has a December year end.

Top Steel is a category C vendor for Value-Added Tax (VAT) purposes. All amounts include VAT where applicable.

Top Steel earns 60% of its income from the sale of the flat steel to its clients and 40% from cash dividends received from the 5 subsidiaries.

Due to the nature of the manufacturing process, the employees have to work in extremely high temperatures with steel dust settling on everything. *Top Steel* has undertaken a few actions to secure contented staff (staff that provides long and continuous service which benefits production).

The company had inaugurated the following schemes for the benefit of its employees:

	Name of scheme	Terms of and benefits paid by the company under the scheme
1	Group Life Scheme	A benefit is paid to the dependents of employees who died in the company's service.
2	Service Bonus Scheme	A bonus is paid upon retirement to any employee who had been in the company's service for a certain period
3	Profit Incentive Scheme	Bonuses paid in February of the following year (once the audited results are available) to employees in divisions that exceeded targets for the current year of assessment. The employees must still be in the employment of *Top Steel* by February when the bonuses are paid.
4	Share scheme	All employees are entitled to purchase shares in *Top Steel* in terms of a performance scheme. The number of shares an employee can purchase is dependent on the employee's own annual individual performance. The purchase and sales of shares to be available for this scheme is done through the TS Employee Share Trust. The rules of the Trust provide that employees can purchase the shares at market value on loan account from the Trust. Shares must be held for at least 3 years. Once the 3 years has expired the employees can sell the shares and settle the loan account. If the employees resign from *Top Steel* in the 3 year period, all shares not held for longer than 3 years are forfeited. The shares held by the Trust to be sold to employees are purchased on the JSE and from employees wishing to sell their shares. In the situation where the Trust has excess shares, it

sold the shares at market value on the JSE. The Trust does not trade in shares at all. During the current year of assessment the Trust made a profit on the sale of shares of R683 400.

The employees did not contribute to any of these schemes. The amount of the benefit or bonus is dependent on the length of service.

The Group Life and Service Bonus schemes are voluntary, and there is no legal obligation on *Top Steel* to make these payments. *Top Steel* can withdraw at any time by means of a general notification to employees.

The following are applicable for the year of assessment ending 31 December 2013:

1. In relation to the various schemes *Top Steel* wants to deduct for income tax purposes:
   - An amount of R850 000 (R250 000 in terms of the Group Life Scheme, R600 000 in respect of the Service Bonus Scheme) actually paid during the year of assessment; and
   - R1 000 000 as a provision in terms of the Profit Incentive Scheme.

2. The interim audit fee paid by *Top Steel* amounted to R1 300 000. The audit work performed covered both the trading and dividend income received by *Top Steel*.

Question 4 Required		Marks	
		Sub-total	Total
a	Identify whether *Top Steel* may deduct the R850 000 (payments in terms of the Group Life and Service Bonus Schemes) in the calculation of its taxable income for the 2013 year of assessment.	13	40
b	Explain the income tax consequences for the employees/ their dependents on receipt of the benefit or bonus in terms of the Group Life Scheme, the Service Bonus Scheme and Profit Incentive Schemes for the 2013 and 2014 years of assessment.	7	
c	Explain whether *Top Steel* may deduct the provision of R1 000 000 in respect of the Profit Incentive Scheme.	3	
d	Explain whether *Top Steel* may deduct the interim audit fee.	6	
e	List the income tax consequences for the TS Employee Share Trust in respect of the profit on the sale of the shares.	7	
f	Identify the dividends tax implications of the dividends declared by the 5 subsidiaries to *Top Steel*.	4	