Tax Professional

Knowledge Competency Assessment

November 2014

Paper 1: 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	General Income Tax Principles	40	Blue
2	Company Tax Advisory	40	White
3	Company Tax Calculation	40	Pink
4	Analysis of Financial Statements	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 tax advisor in the employment of TaxPerts (Pty) Ltd, a South African company that renders tax advisory services. The following matters have been presented to you:

Matter 1

Steve McGarret, 28 years of age and unmarried, is a qualified financial advisor. Steve was appointed as financial advisor by Finance Solutions (a financial advisory firm in Pretoria) on 1 January 2012. He lives in a security complex in Centurion (a Pretoria suburb) with his younger sister, Denise, who is 20 years of age and the Commissioner for the South African Revenue Service (SARS) accepts that she is a person with a disability. Steve and Denise's parents are deceased, resulting in Steve being responsible for Denise's care and maintenance.

Steve was seconded to Finance Solutions' Melbourne office in Australia for the whole of May 2014 to assist with providing financial advice on a big client project there. He left South Africa on 28 April 2014 and arrived back in the country on 4 June 2014.

Steve was again seconded to the Melbourne office during the period 1 August 2014 to 31 December 2014, after which he returned to South Africa.

A qualified nurse looks after Denise while Steve is absent from South Africa.

Matter 2

Jenny Fuller, a physiotherapist is a 42-year of South African resident whose physiotherapy practice is situated in East London.

In 2004 Jenny inherited a large sum of money from her late aunt which she used to purchase a block of flats in East London. The flats were acquired in 2005 at a cost of R2 million and Jenny has derived rental income from the flats for the past 10 years.

Jenny has now decided to sell the block of flats because she wants to immigrate to Canada and does not want to manage her investment thousands of kilometres from where she lives. She has consulted an estate agent who has advised her that he could sell the property in one of two ways:

- Jenny could sell the entire block of flats as one property in its present condition.
- Alternatively, she 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 R7 million. He has told Jenny that if she spends R750 000 on upgrading the building and opening a sectional title register she can expect to sell the flats for R8.5 million in total. Jenny is not a VAT vendor.

Matter 3

Tony Stark, a 35-year old resident, was paid a salary of R50 000 and commission of R70 000 by Avengers (Pty) Ltd ("Avengers"), a South African company that sells action figures. These amounts were paid for the period in which Tony was employed by the company, namely 1 September 2014 to 28 February 2015.

During the abovementioned period Tony frequently worked from his study at his house and spent R18 000 on the acquisition of a computer, stationery and internet- and telephone usage specifically for his study. Tony used the study exclusively for the work he did regarding the sale of Avengers action figures and equipped it specifically for that purpose. Tony spent 70% of the time he worked for the company, working from his study. The rest of his workdays Tony worked from the office provided to him at Avengers' business premises. Tony had no other receipts or accruals for the 2015 year of assessment.

Question 1 Required		Marks	
		Sub-Total	Total
a	Matter 1 Explain whether or not Steve would be considered a South African resident for the whole or part of the 2015 year of assessment. *Support your answer with reference to relevant legislation and case law.* *Communication skills – logic and argumentation*	9 1	10
b	Matter 2 Discuss whether the proceeds from the sale of the property as: • a single property; and • as sectional title units would be of an income or capital nature in Jenny Fuller's hands. *Support your answer with reference to relevant case law*. *Communication skills – layout and presentation*	19 1	20
c	Matter 3 Explain to Tony Stark whether or not the expenditure incurred by him in respect of his study is deductible for tax purposes. *Support your answer with reference to relevant legislation.* *You can accept that the abovementioned expenditure was actually incurred. No discussion of section 11 is required.* *Communication skills – presentation and layout*	9 1	10
	Total		40

Question 2 40 marks

William Wordsworth, aged 42, is a South African resident. He is unmarried and has no dependants. William owns a couple of bookshops in South Africa as a sole proprietor and sells both new and second-hand books. He wishes to structure his business in the most tax-efficient way and has approached you, a tax trainee at a firm in Cape Town, to assist him with his queries. William is not registered as a VAT vendor. His bookkeeper has provided you with a statement of his income and expenditure in respect of the year of assessment ending 28 February 2015 (you may assume these amounts are correct):

Statement of Income and Expenditure for the year ended 28 February 2015

	R	R
Turnover		910 000
Cash sales	900 000	
Credit sales	10 000	
Less: Cost of sales		(437 000)
Gross profit		473 000
Plus: local interest income received		24 000
Less: Tax-deductible expenditure		(220 000)
Operating expenses	68 000	
Rental of shop space	152 000	
Profit before tax		277 000

William has not earned any other income. He is considering establishing a private company through which he can run his business, but is unsure of the tax implications of this. William has never formed a company before. The only shares he owns are 1000 shares in Barloworld Limited, which he inherited from his late father in 2008.

Additional information (relevant only in respect of part (d) of the required)

William formed a private company, Wordsworth (Pty) Ltd, on 1 March 2014, of which he is the sole shareholder and financial director. He now employs seven full-time staff members. Although William has a bookkeeper who deals with the accounting and payroll issues, William is ultimately responsible for signing off on all payments. The bookkeeper sent you the following e-mail:

To: <Tax Trainee>

From: <Bookkeeper>

Date: 31 October 2014

Subject: CONFIDENTIAL: Employees' tax

Dear Tax Trainee

I am writing this e-mail to you in the strictest of confidence. As you know, I perform the bookkeeping function at Wordsworth (Pty) Ltd and am also the representative taxpayer of the company. Mr Wordsworth has refused to sign the payment of the monthly employees' tax to SARS for the past three months. I have repeatedly raised this matter with Mr Wordsworth and our Human Resources Manager, but to no avail.

Mr Wordsworth is of the opinion that "SARS can wait". He said that he used the money (which amounts to roughly R250 000) to import a new series of books from the USA.

I know that the money is supposed to be paid over to SARS in terms of the Fourth Schedule to the Income Tax Act, so I am worried that I might be held personally liable for the outstanding tax.

Please advise?!

Bookkeeper

<table>
<tr><td colspan="2">Question 2

Required</td><td>Total</td></tr>
<tr><td colspan="2">

- *Answer the questions below.*
- *Show all calculations.*
- *Round off all amounts to the nearest Rand.*
- *You are not required to provide references to case law or to provisions in the legislation.*

</td><td></td></tr>
<tr><td>a</td><td>Inform Mr Wordsworth of the general business pros and cons associated with carrying on business as
• a sole proprietorship; and
• a private company.
You are not required to address any tax related considerations in this part.</td><td>10</td></tr>
<tr><td>b</td><td>Assuming that Mr Wordsworth chooses the private company option, briefly explain whether or not his company would qualify as a small business corporation in terms of the Income Tax Act No. 58 of 1962.</td><td>7</td></tr>
<tr><td>c</td><td>Evaluate which of the following options is the most tax-efficient in Mr Wordsworth's circumstances:
• sole proprietor;
• small business corporation;
• micro business company.
Ignore employees' tax, provisional tax and VAT.</td><td>15</td></tr>
<tr><td>d</td><td>Refer to the additional information e-mail.
Advise the bookkeeper as to whether she or Mr Wordsworth could be held personally liable for the R250 000 employees' tax debt in terms of the Tax Administration Act No. 28 of 2011.
You need not address any applicable penalties or the procedures for the recovery of tax.</td><td>8</td></tr>
<tr><td></td><td>Total</td><td>40</td></tr>
</table>

Question 3 40 marks

You are a tax consultant at a local accounting and auditing firm. You receive queries from clients on a daily basis in respect of the tax treatment of various transactions. It is your firm's policy to always advise clients in such a manner that they will be liable for the minimum tax possible, but still adhere to tax legislation. You receive the following unrelated queries from some of the firm's clients:

Query 1

Moolicious Ltd ("Moo"), with a 31 August year-end, is a local client that manufactures and sells dairy products. The Commissioner recognises this process as a process of manufacture. Moo had a capital loss of R10 000 on 31 August 2013.

1. Factory

The company leased a factory building from 1 December 2013 to increase their manufacturing capacity by 30%. The factory is fully utilised in the manufacturing of dairy products. The lease rental paid on the factory amounts to R14 250 per month. The lease agreement states that Moo is obliged to erect improvements with a market value of R592 800 to the factory.

Moo did not have sufficient funds available to erect the improvements. The improvements were erected by Mr John Milkybar and were completed and brought into use on 1 February 2014. Moo appointed a valuator who determined that the market value of the improvements on 1 February 2014 was R776 640. The lease agreement expires on 30 November 2025, but Moo has the option to renew the contract with an additional three years.

John Milkybar is the only shareholder of Moo and he has his own construction business where he trades as a sole proprietor. The terms and conditions of the loan agreement entered into with Mr John Milkybar, are as follows:

- Total loan amount: R681 263.
- The loan is payable in two equal annual instalments of R397 812 each, payable on 31 January 2015 and 31 January 2016 respectively.
- The loan is redeemable in full on 31 January 2016.
- The loan bears interest at the prime borrowing rate.
- No asset is pledged as security for the loan.

The yield to maturity is 11%.

2. Sales representatives

Moo contracted with Daisy Donalds, a woman operating her own personnel agency as sole proprietor, to provide ten sales representatives to the company for the period 1 July 2014 to 31 May 2015 to market Moo's products. The salary cost for each sales representative amounts to R10 000 per month. In terms of the agreement entered into with Daisy Donalds, Moo must pay the full cost of the sales representatives for the whole contracting period as a once-off amount on 31 August 2014.

3. Milk purchases

Moo purchases milk from a local milk farmer. Moo placed an order for 9 300 litres of milk at a cost of R8 per litre on 1 August 2014. Moo paid for the entire order on 10 August 2014 and it was specified that the milk had to be delivered as follows:

10 August 2014	1 300 litre
25 August 2014	1 400 litre
10 September 2014	1 500 litre
25 September 2014	1 600 litre
10 October 2014	1 700 litre
25 October 2014	1 800 litre
Total	9 300 litre

20% of all milk delivered from 1 July 2014 is utilised for research, while the rest of the milk is used for the manufacturing of dairy products. All milk is ordered under the terms of 'cost, insurance and freight' (CIF).

According to the factory manager's report 30% of the milk delivered on 25 August 2014 was still on hand on 31 August 2014. On 31 August 2014 the research manager reported that 15% of the milk delivered on 25 August 2014 was still on hand. This was the only milk that was on hand at year-end.

4. Milk-heating machine

Moo sold a milk-heating machine that was used in its manufacturing process for R233 700 on 1 July 2014. The machine was purchased second hand from an unrelated party on 1 October 2012 at a cost of R210 000. The machine's market value on the date Moo purchased it was R216 600.

Ignore Value Added Tax (VAT) for purposes of this query.
You may also assume that Moolicious does not qualify as a Small Business Corporation and that the research conducted by them meets the requirements of s11D and is approved as such by the Minister of Science and Technology.

Query 2

Eastvale Trust ("Eastvale'), a South African resident trust, owns 20 000 shares (a 3% shareholding) in Shire Limited ("Shire"), a South African company. The shares were purchased for R110 000 on 1 December 2007. Eastvale makes use of the weighted average method to identify their share sales.

Shire's board of directors declared a cash dividend of R0,33 per share on 1 June 2014. The dividend was payable to shareholders registered on 30 June 2014 and the dividend was paid on 10 July 2014. The board of directors indicated that R45 000 of the amount declared represented a reduction in the company's contributed tax capital. Shire's board of directors also determined that shareholders who qualified for an exemption under section 64F or 64G of the Act had to submit the necessary declarations in the prescribed form before 1 July 2014. Shire had an STC credit balance of R10 000 immediately before the dividend declaration.

Question 3 Required		Marks Sub-total	 Total
a	*Refer to Query 1 only* Calculate the total effect of the above transactions on Moolicious Ltd's taxable income for the year of assessment ended 31 August 2014. *You are required to refer to relevant tax legislation and to provide reasons in order to support your calculations only in respect of the transaction(s) with the personnel agency.* *Show detail calculations.* *Round all amounts off to the nearest Rand.*	31	32
	Communication skills – presentation and layout	1	
b	*Refer to Query 2 only* Calculate the amount of the dividend payable to Eastvale Trust as well as the dividends tax (if any) that Shire Limited must withhold in respect of the dividend declaration on 1 June 2014. Your answer must clearly indicate the amount which may be subject to dividends tax. Also indicate if there is no dividends tax liability on a specific item and give a brief reason why. *Show detailed calculations and round off amounts to the nearest Rand.* *You may assume that Eastvale Trust was registered as a shareholder on 30 June 2014.*		4
c	*Refer to Query 2 only* Indicate the date on which the dividend is paid, in respect of the dividend declaration on 1 June 2014. Indicate further the date on which the dividends tax (if any) must be paid to SARS. Give a short reason for your answer.		4
	Total		40

Question 4 — 40 marks

Fleming Ltd ("Fleming") is a resident company and a registered VAT vendor. 99% of Fleming's supplies are taxable supplies. Fleming is listed on the JSE Securities Exchange and manufactures clothing and textiles for the export wholesale market.

Fleming is a wholly-owned subsidiary of Bleuchamp Co Ltd ("Bleuchamp"), a company that is a resident of Mauritius. Bleuchamp is taxed in Mauritius on its worldwide income at a rate of 15%.

You are provided with the following extract from the financial statements for the year ended 31 December 2014:

Fleming Limited

Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 December 2014

	Notes	2014 R	2013 R
Revenue	1	40,000,000	50,000,000
Cost of sales		(30,000,000)	(25,000,000)
Gross profit		10,000,000	25,000,000
Dividend income	2	1,400,000	-
Depreciation expense		(1,000,000)	(1,000,000)
Motor vehicle expenses	3	(50,000)	(50,000)
Employee costs	4	(3,500,000)	(2,500,000)
Sundry expenses	5	(560,000)	(200,000)
Finance costs	6	(2,000,000)	-
Profit before tax		4,290,000	21,250,000

Notes and additional information

1. During 2013, sales consisted wholly of exports to wholesalers in Europe. As of 1 January 2014, all sales are made to Bluechamp in Mauritius and from there the goods are distributed to wholesalers in Europe.

2. On 15 March 2014 Fleming acquired 90% of the shares Andolini spA, an Italian holding company that owns shares in a number of European companies. Andolini spA declared and paid a dividend of €100 000 to Fleming on 25 August 2014. The dividend received was converted at the average exchange rate for the year of R14: €1 and included in the financial statements.

3. In March 2014 a motor car, as defined in the Value-Added Tax Act, belonging to Fleming was written off in an accident. The other motor car involved in this accident – owned by an unrelated party – was also written off. Fleming's driver was the guilty party in this accident. Delta Insurance Company limited paid R114 000 to Fleming on 31 March 2014 in respect of Fleming's written off motor car. The financial accountant recorded the transaction as follows:

	R	R
DR Cash and cash equivalents	114 000	
CR Motor vehicles		100 000
CR VAT control		14 000

Proceeds received from insurer in respect of motor car written off

Fleming's policy with Delta Insurance Company also includes cover for third-party claims. Delta Insurance Company therefore paid the other party involved in the accident R250 000 in respect of his claim for his written off motor car. Fleming, wishing to maintain its good public image, agreed to pay a further amount of R20 000 to the other party and recorded the following entry:

	R	R
DR Motor car expenses	17 543	
DR VAT control	2 456	
CR Bank		20 000

Payment made to other party involved in the car accident

4. Employee costs for 2014 consist of:

	R
Salaries and wages	3 000 000
Performance bonus accrual (bonuses will be paid in January 2015)	500 000
Total	3 500 000

5. Sundry expenses consist of:

	R
Restraint of trade payment made to rival company	100 000
Traffic fines paid	50 000
SARS penalty for late payment of employees' tax	10 000
Fair value adjustment on investment property	400 000
Total	560 000

6. Bleuchamp advanced a loan of R5 000 000 to Fleming on 1 January 2014. The loan bears interest at 20% and is used to fund operating expenditure.

Question 4 Required		Marks	
		Sub-total	Total
a	Reconcile the profit before tax with the taxable income of Fleming Ltd for the 2014 year of assessment. Your answer must deal with every item listed in the statement of profit or loss and other comprehensive income. Support your answer with brief reasons and/or references to legislation. For the purposes of this part you may – • Assume that the Commissioner of SARS allows a deduction of R1 200 000 for capital allowances in respect of Fleming's assets; • Assume that the journal entries in note 3 are correct; and • Ignore the provisions of s9D and s31.		13
b	Based on your answer in part (a), calculate the effective tax rate of Fleming Ltd for the year of assessment ended 31 December 2014.		2
c	Provide the correcting journal entries, if any, in respect of the information listed in note 3 along with the appropriate narrations. *Support your answer with reasons and/or references to legislation.*		12
d	Identify at least 5 tax risks that are evident from the information provided.		13