# Tax Professional

## Knowledge Competency Assessment

Sample Paper 1: Question

South African
Institute of
Tax Professionals

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 | Various – Advisory | 50 | Colour A |
| 2 | VAT, CGT and Capital Allowances | 30 | Colour B |
| 3 | Normal Tax Calculation | 40 | Colour C |
| 4 | Analysis of Financial Statements | 40 | Colour D |

Total marks: 160

Time: 4 hours plus ½hour 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 — 50 marks

This question consists of two parts and are unrelated.

## Part A — 40 marks

You are a registered South African tax practitioner and a registered Value-Added-Tax (VAT) vendor. You have received the following unrelated enquiries from two of your clients.

### Enquiry 1

Buzz Lightyear Estate (Pty) Ltd ('BLE'), a South African estate agent and a registered VAT vendor, wants to motivate its estate agents, some of whom are employees and others who are independent agents, to work harder in finding more properties to sell and increase its profits. The company is considering offering an overseas holiday to the person that brings in the highest amount of commission.

The owner of BLE, Buzz Lightyear, owns a house on a Greek island in Europe, and is prepared to allow the winner to stay in the house for two weeks and for BLE to pay for the winner's flight ticket. The winner will not be able to sell or exchange the prize and if the winner cannot go within a period of twelve months, the winner will forfeit the prize. The last condition relating to the prize will require the winner to give BLE three months' notice to book and finalise the trip.

Buzz Lightyear does not want any payment from BLE for the use of the house because he is the main member of the company and only rents out the house during the European holiday season when he and his family are unable to use it. He is concerned about the tax implications that may arise from allowing the winner to occupy the house.

| Question 1 Part A: Enquiry 1<br>Required | Marks<br>Total |
|---|---|
| Explain all the possible tax implications that will arise for both Buzz Lightyear Estate (Pty) Ltd (BLE) andthe potential winner of the prize as a result of the proposed transaction.<br>*Your answer should make reference to appropriate provisions of legislation and appropriate case law where applicable.*<br>*You are not required to discuss any tax implications for Buzz Lightyear himself.*<br>*In answering this enquiry you may assume that none of the employees or the independent agents are VAT vendors.* | 28 |

## Enquiry 2

SwissHills Hotel (Pty) Ltd trades as 'Swills Hotel' in the KwaZulu Natal Midlands. It has an October year-end and is a registered VAT vendor. Potential guests of the Swills Hotel are required to pay a deposit to the Swills Hotel when they make a reservation to stay at the hotel. The accountant of the Swills Hotel has opened a special bank account and always maintains a minimum balance in the account of at least R10 000 for possible refund or deposit claims.

Swills Hotel received R114 000 in deposits during the year of assessment ended 31 October 2013. This amount was taken from the actual invoice totals and not from the accounting records.

All deposits are forfeited should guests be unable to take up their holiday and stay at the hotel. During the last two years the Swills Hotel's reservations outside of peak holiday season during the year have declined and the accountant is convinced it is because the Swills Hotel does not refund deposits when reservations are cancelled unless extraordinary events occur, for example in the case of death.

For the 2014 year of assessment, the accountant proposed a dual system of dealing with deposits that will work as follows:

- During peak holiday seasons: Deposits paid will be forfeited in case of cancellation.
- Outside of peak holiday seasons: Deposits will be refundable in case of cancellations made more than 24 hours before the reserved date.

| Question 1 Part A: Enquiry 2<br>Required | | Marks | |
|---|---|---|---|
| | | Sub-Total | Total |
| a | Explain the South African tax implications relating to the deposits of R114 000 in the year of assessment ended 31 October 2013.<br>*Your answer should make reference to appropriate provisions of legislation and appropriate case law where applicable.* | 7 | |
| b | Discuss what the income tax implications of the newly proposed refundable deposit system will be if all current legislation remains applicable and total deposits will again be R114 000, with 50% of the amounts received relating to refundable deposits.<br>*Your answer should make reference to appropriate provisions of legislation and appropriate case law where applicable.*<br>*For purposes of answering this part of the enquiry you may assume that Swills Hotel will keep all other practices in place except that the Swills Hotel will increase the balance in the special account to R20 000.* | 5 | 12 |

## Part B 10 marks

Laddies (Pty) Ltd will be renting premises from 1 March 2014 from Lords (Pty) Ltd in terms of a 10 year lease agreement. Laddies (Pty) Ltd has a financial year-end of 30 April and will be using the property in its manufacturing process.

Laddies (Pty) Ltd can choose between the following two options to structure the agreement. Both options will result in R6 000 000 payable over the 10 year period.

### Option 1:

- Once-off payment of R1 200 000 on 1 March 2014 for the right to use the building.
- Monthly rental of R40 000 for 10 years.
- For the first month of the agreement (March 2014) the monthly rental is payable in arrears (thus payable on 31 March 2014). As from April 2014, the monthly rental becomes payable on the last day of the previous month. For example, the rental for April 2014 is payable on 31 March 2014 and the rental for May 2014 is payable on 30 April 2014.

### Option 2:

- Annual rental of R600 000 payable in advance.
- The rental for the first year of the agreement is therefore payable on 1 March 2014.

You may assume that Laddies (Pty) Ltd will make no other advance payments during its 2014 year of assessment.

| Question 1 Part B<br>Required | Marks<br>Total |
|---|---|
| Advise Laddies (Pty) Ltd which option will result in the lowest taxable income for its year of assessment ending 30 April 2014.<br>*Support your answer with calculations and make reference to appropriate provisions of legislation.*<br>*Ignore VAT.* | 10 |

## Question 2 30 marks

Smokey (Pty) Ltd ('Smokey') manufactures a special type of braai and is a Category B Value-Added-Tax (VAT) vendor with a March year end.

The company's warehouse was completely destroyed by a fire on 10 January 2013. On 18 January 2013, Smokey's insurance company paid it R1 500 000, which represented the replacement value of the destroyed building. No amount was paid in respect of the land which had a market value of R800 000 on that date. When the land and warehouse were acquired on 19 June 2007 from a developer for R450 000, no split was made between the cost of the land and the warehouse but paragraph 33 of the Eighth Schedule will be applied on disposal. The building did not qualify for any capital allowances.

Smokey decided not to rebuild the warehouse, but rather to use part of the insurance payout to purchase a new building, as a replacement asset, to be used as its Head Office. The purchase contract between Smokey and a non-vendor was concluded on 26 January 2013. The purchase price agreed upon was R1 250 000 (the cost of the land was insignificant and can be ignored). The building was brought into use on 13 March 2013 – the date on which payment was made of the applicable transfer duty and registration in Smokey's name took place. Half of the purchase price was paid in cash on this date and the remaining 50% was payable on 13 May 2013.

The remainder of the insurance payout was used for the acquisition of a second replacement asset, a new delivery vehicle (not a *motor car* as defined in the VAT Act). The vehicle was purchased on 28 February 2013 in terms of an instalment sale agreement (ISA) and immediately brought into use. The cash cost would have been R580 000, but Smokey paid a deposit of R145 000 and will pay the outstanding balance of R435 000 plus finance charges in 36 monthly instalments of R15 080 each. The first instalment was paid on 1 April 2013. Finance charges (calculated in terms of section 24J) amounted to R5 438 and R55 404 for the 2013 and 2014 years of assessment respectively.

During February 2013, the company paid a contractor R130 000 to clear the land of rubble from the destroyed building and sold the land on 28 March 2013 for R900 000. The sale was subject to a condition that the buyer's mortgage bond finance be approved. The buyer successfully obtained bond finance on 2 April 2013. The land was registered in the buyer's name on 10 May 2013 and Smokey received the R900 000 cash on this date.

## Additional information:

- All amounts include VAT where applicable.
- Smokey makes 100% taxable supplies.
- Smokey claims all the input tax deductions it is entitled to and is in possession of the relevant documentation in support of such claims.
- Where legally possible, Smokey will elect to postpone any normal tax liability.
- In terms of Binding General Ruling No. 7 (Interpretation Note 47), wear-and-tear on delivery vehicles is allowed over four years.
- Smokey made no other disposals during its 2013 or 2014 years of assessment.

| Question 2<br>Required | | Marks | |
|---|---|---|---|
| | | Sub-Total | Total |
| a | List, supported with calculations, the VAT and Transfer Duty consequences for Smokey (Pty) Ltd of all the transactions described above during all the tax periods falling within its 2013 year of assessment.<br>*Specifically state when output tax must be declared or when the input tax can be claimed.*<br>*References to legislation are not required.* | 14 | |
| b | Calculate the effect of the the above transactions on Smokey's taxable income for its 2013 year of assessment.<br>*Support capital allowances with references to appropriate provisions of legislation.* | 16 | 30 |

## Question 3 40 marks

This question consists of two related parts.

Lavender Decor Limited ('Lavender'), a South African resident company, manufactures and sells home décor items. This process is classified as a *process of manufacture* for purposes of the Income Tax Act. The company is a registered Value-Added-Tax (VAT) vendor with a 30 September financial year-end.

Lavender is neither a listed company nor a small business corporation as defined in section 12E of the Income Tax Act.

## Part A 32 marks

Lavender's accountant, Les, has done a preliminary tax calculation for the year of assessment ended 30 September 2013. She has determined a taxable income of R1 980 000.

The income tax effect of the following items have not yet been taken into account in the calculation of the taxable income of R1 980 000, as Les was uncertain as to the correct tax treatment of the items.

All amounts in the question exclude VAT, unless specifically stated otherwise.

Lavender had an assessed capital loss, as envisaged in paragraph 9 of the Eighth Schedule to the Income Tax Act, of R15 000 carried forward from the 2012 year of assessment.

1. Fixed assets

   1.1 A second-hand engraver was purchased for R10 000 and brought into use in the manufacturing process on 1 June 2013. A delivery cost of R800 was incurred to deliver the engraver at Lavender's premises. SARS' Binding General Ruling 7 (Interpretation Note No. 47) allows for a write-off period of 5 years on this type of equipment.

   1.2 Woodworking tools to the total value of R5 600 were purchased on 15 January 2013.

   1.3 A new machine cutter, used in the manufacturing process, was imported from London at a total cost of £50 000. The order was placed on 5 July 2013 and the machine was shipped free on board (FOB) on 1 August 2013. It was delivered at Lavender's premises on 5 September 2013 and brought into use on the same day. A forward exchange contract (FEC) for a three-month period at a forward rate of £1 = R11.85 was entered into on 1 September 2013 to serve as a hedge against the debt. The debt was settled on 31 October 2013.

   The following exchange rates are applicable:

| Date | Spot Rate |
|---|---|
| | £1 = R |
| 5 July 2013 | £1 = R11.90 |
| 1 August 2013 | £1 = R11.75 |
| 1 September 2013 | £1 = R11.70 |
| 5 September 2013 | £1 = R11.83 |
| 30 September 2013 | £1 = R11.80 |
| 31 October 2013 | £1 = R11.94 |

   FEC rate 30 September 2014, market related for one-month period: £1 = R11.82

   Average exchange rate for 2013 year of assessment: £1 = R11.82

1.4 Lavender bought a scale, being one of the assets used in the process of manufacture, from one of its shareholders for R80 000 on 1 November 2012.

The shareholder holds a 40% interest in Lavender. The shareholder originally purchased the machine for R70 000 and has claimed allowances of R14 000 on the asset until the date of sale. A recoupment under section 8(4)(*a*) of R14 000 and a capital gain of R10 000 resulted from the sale transaction.

1.5 Lavender owns the building from which it conducts its manufacturing process. The building was purchased on 1 October 2001 at a cost of R1 500 000.

1.6 On 1 March 2013, an old brass burner, Machine BB1, used in the manufacturing process, was sold for R547 200 (including VAT) to an independent third party.Machine BB1 was purchased and brought into use during the 2008 year of assessment and had already been written-off in full for tax purposes at 1 October 2012 (tax value = Rnil). The original cost price amounted to R400 000 (excluding VAT).Machine BB1 was replaced with a new brass burner, Machine BB2, that was purchased on 15 June 2013 for R1 350 000.Lavender elected par 66 of the Eight Schedule to be applied to this transaction.

2. Learnership agreement

Lavender entered into a 10-month registered learnership agreement with Jean Bothe, a person with a disability, on 1 November 2012. You may assume that the learnership was successfully completed on 31 August 2013.

3. Doubtful debts

The Commissioner allowed 25% of the doubtful debt provision of R75 000 for tax purposes in the 2012 year of assessment. The allowance for doubtful debts was increased by R25 000 for the 2013 year of assessment and 25% of this allowance will be allowed by the Commissioner.

4. Lump sum paid to retired employee

   An amount of R120 000 was paid directly to one of Lavender's employees who retired at the age of 65. This payment was made to cover his post-retirement medical aid contributions.

5. Trading inventory

   5.1 On 1 August 2013, Lavender purchased raw material to the value of R1 400 000. 20% of this raw material was still on hand at year end. Lavender had no raw material on hand on 1 October 2012.

   5.2 A table lamp was donated to be auctioned in favour of the "Save-the-Rhino" fund (a Public Benefit Organisation) on 1 September 2013. The lamp had a cost price of R17 500 and a market value of R35 000 on the date of donation. A section 18A receipt was obtained in respect of this donation. The lamp was not included in closing inventory.

| Question 3 Part A<br>Required | Marks<br>Total |
|---|---|
| Calculate the normal tax liability of Lavender Decor Ltd for the company's year of assessment ending 30 September 2013.<br>*Begin your calculations with the supplied starting taxable income of R1 980 000.*<br>*Show all your calculations.*<br>*Indicate, with reasons, if an amount has no tax implications and round-off all amounts to the nearest Rand.* | 32 |

## Part B 8 marks

Lavender Decor Ltd has not paid a dividend since September 2011. Les informs you that Lavender would like to declare a dividend of R100 per share on 15 October 2013, payable to the shareholders on 22 November 2013. Lavender's shares are owned by the following (the shareholding has not changed since the company was formed):

| Shareholder | Number of shares held |
|---|---|
| May Peaches (South African resident individual) | 10 000 |
| Lavender Family Trust (South African resident trust) | 70 000 |
| Pealave (Pty) Ltd (South African resident family investment company) | 20 000 |
| Total number of shares in issue | 100 000 |

Les would like to know how this dividend will be treated for dividends tax purposes.

| Question 3 Part B<br>Required | Marks<br>Total |
|---|---|
| Advise Les of the dividend tax implications in respect of the dividend that Lavender Decor Ltd wishes to declare to its shareholders.<br>Include an explanation of the administrative requirements of the dividend tax provisions in the Income Tax Act. | 8 |

## Question 4 — 40 marks

You are the tax manager of Books Galore (Pty) Ltd ('BGL'). The company was selected for an audit by the South African Revenue Service (SARS). The Financial Director of BGL is concerned about certain accounts in the financial statements from a tax perspective and has asked you to identify possible tax risks from the information provided.

The Financial Director has provided you with certain background information to the company, extracts of the notes to the financial statements and the detailed operating expenses schedule.

| Question 4<br>Required | Marks<br>Total |
|---|---|
| Critically analyse the information provided and identify the possible tax risks. | 40 |

## Background information to Books Galore Limited

The company prints and publishes books. The company was registered in South Africa during January 2005. The original year-end was 28/29 February, but during the last general meeting it was decided to change the year-end to 31 October to be in line with the holding company, The Book Club Limited. Both the company and its holding company are managed and controlled in South Africa. The special resolution changing the year end was registered with the Registrar to comply with the Companies Act. The Commissioner of SARS was also notified of the change.

Mr. Galore, not a shareholder of BGL was appointed as Public Officer of BGL on 5 January 2005. His details are as follows:
Identity number: 600314 0066 083
Cell phone number: 082 123 4567
Residential address: 56 Main Street, Waterkloof, 9876.

Included in the R1 585 000 (refer note 10) bonuses provided for at year end, is an amount of R567 456 which depends on the final results of the company (profits) and the performance of employees during the year. It is however not yet certain if the total provision will be paid out, as the employee performance evaluations have not yet been finalised.

Mr. Galore was arrested for drunk driving. He could only make one phone call from jail and he phoned the company's accountant. Mr. Galore requested the accountant to cash a company cheque of R15 000 to bail him out. He also requested him to account for the cheque as legal fees in the company's records (refer detailed Statement of Profit or Loss and Other Comprehensive Income). This was not picked up by the auditors during the year-end audit.

Included in 'Entertainment' is an amount of R10 675 paid to "The Party Farm". This amount was paid in respect of Gallo's (Mr. Galore's daughter) 21st birthday party.

Donations of R1 000 consist of the following:

- R500 was paid to Boys Town. No section 18A certificate was received.
- R500 given to homeless people in Pretoria.

Included in consulting fees is an amount of R78 732 paid to TaxServe. The tax firm assisted BGL with an objection to SARS. The objection related to certain expenses claimed in the 2011 IT14, which SARS disallowed. The objection was rejected and the assessment made final.

Sundry income of R4 079 consists of local dividends received. It appears as if it was incorrectly classified as sundry income and not investment income in the Annual Financial Statements.

Mr. Galore also owns 50% membership interest in a CC registered in South Africa.

The audit report was not qualified.

The company has no foreign investments.

Books Galore Limited

(Registration number 2005/000008/07)

Financial Statements for the period ended 31 October 2013

Notes to the Financial Statements

## 3. Intangible assets

| | Oct 2013 | | | Feb 2013 | | |
|---|---|---|---|---|---|---|
| | Cost | Accumulated amortisation | Carrying value | Cost | Accumulated amortization | Carrying value |
| Patent | 71 188 | (41 794) | 29 394 | 71 188 | (39 227) | 31 961 |

**Reconciliation of intangible assets – October 2013**

| | Opening balance | Amortisation | Total |
|---|---|---|---|
| Patent | 31 961 | (2 567) | 29 394 |

**Reconciliation of intangible assets – Feb 2013**

| | Opening balance | Amortisation | Total |
|---|---|---|---|
| Patent | 35 513 | (3 552) | 31 961 |

## 4. Loan to group company

| | Oct 2013 | Feb 2013 |
|---|---|---|
| **Loans and receivables** | | |
| Not So Incredible (Pty) Ltd | 9 171 041 | 8 830 124 |
| The loan is unsecured and bears interest at 4.5% per annum (28 Feb 2013:6%). The loan is repayable by mutual agreement. | | |
| **Current assets** | | |
| Loans and receivables | 9 171 041 | 8 830 124 |

## 7. Trade and other receivables

| | | |
|---|---|---|
| Trade receivables | 37 465 379 | 45 051 438 |
| Prepayments | - | 36 593 |
| VAT | 1 206 626 | - |
| Other receivables | 1 622 373 | 195 107 |
| | **40 294 378** | **45 283 138** |

All amounts are short-term. The carrying value of trade receivables is considered a reasonable approximation of fair value.

All of the trade receivables have been reviewed for indicators of impairment. None were found to be impaired.

Some of the unimpaired trade receivables are past due as at the reporting date. The age of financial assets past due but not impaired is as follows:

| | | |
|---|---|---|
| Not more than 3 months | 3 982 209 | 5 134 656 |
| More than 3 months but not more than 6 months | 847 313 | 557 957 |
| More than 6 months but not more than 1 year | 311 986 | 1 330 348 |
| More than 1 year | 492 051 | 61 533 |
| | **5 633 559** | **7 084 494** |

## 8. Cash and cash equivalents

Cash and cash equivalent consist of:

| | | |
|---|---|---|
| Cash on hand | 10 000 | 5 000 |
| Bank balances | 11 969 852 | 91 831 616 |
| Short-term deposits | 32 390 620 | - |
| | **44 370 472** | **91 836 616** |

Books Galore Limited
(Registration number 2005/000008/07)
Financial Statements for the period ended 31 October 2013

Notes to the Financial Statements

## 10. Trade and other payables

| | | |
|---|---|---|
| Trade payables | 17 830 048 | 6 585 837 |
| VAT | - | 2 207 520 |
| Provision for bonuses | 1 585 000 | 225 641 |
| Accrued leave pay | 309 696 | 395 990 |
| Accrued expenses | 3 105 558 | 174 454 |
| Other payables | 360 696 | 157 235 |
| | **23 190 998** | **9 746 677** |

All amounts are short-term. The carrying values are considered to be a reasonable approximation of fair value.

## 12. Investment revenue

| | | |
|---|---|---|
| **Interest revenue** | | |
| Not So Incredible (Pty) Ltd | 503 018 | 488 384 |
| Bank | 1 595 661 | - |
| | **2 098 679** | **488 384** |

## 13. Finance costs

| | | |
|---|---|---|
| Bank overdraft | 3 696 | - |
| South African Revenue Service | 7 326 | 10 625 |
| | **11 022** | **10 625** |

## 22. Comparative figures

The current year represents an 8 month period as the company changed its year end from February to October.

Comparative figures have been reclassified in certain instances.

Books Galore Limited
(Registration number 2005/000008/07)
Financial Statements for the period ended 31 October 2013

The supplementary information presented does not form part of the financial statements and is unaudited

Detailed Operating Expenses

| | Note(s) | 8 months ended 31 October 2013 R | 12 months Ended 28 February 2013 R |
|---|---|---|---|
| Advertising | | 5 586 836 | 5 072 740 |
| Annual duty | | 4 000 | - |
| Auditor's remuneration | | 424 973 | 170 000 |
| Bad debts | | 20 891 | 233 144 |
| Bank charges | | 221 281 | 238 473 |
| Cleaning | | 202 159 | 117 434 |
| Commission paid | | 798 113 | - |
| Computer expenses | | 209 837 | 296 137 |
| Consultancy fees | | 91 893 | 208 147 |
| Consumables | | 1 930 | - |
| Delivery expense | | 70 520 | 305 362 |
| Depreciation and amortization | | 380 076 | 606 293 |
| Donations | | 1 000 | 2 020 |
| Employee costs | | 11 230 921 | 23 412 943 |
| Entertainment | | 154 693 | 239 700 |
| Fines and penalties | | 100 | 12 550 |
| First aid equipment | | 3 518 | - |
| Gifts and promotions | | 597 857 | 1 099 879 |
| Insurance | | 192 173 | 375 808 |
| Lease rentals on operating lease | | 394 943 | 1 007 547 |
| Legal expenses | | 21 569 | 111 697 |
| Licences | | 8 583 | 82 414 |

Books Galore Limited
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Financial Statements for the period ended 31 October 2013

Detailed Operating Expenses (continued)

| | Note(s) | 10 months Ended 31 October 2013 R | 12 months ended 28 February 2013 R |
|---|---|---|---|
| Levies | | - | 151 987 |
| Loss on foreign exchange differences | | 29 513 | - |
| Management fees (related party) | | 3 941 444 | - |
| Membership fees | | 142 281 | 96 484 |
| Motor vehicle expenses | | 40 180 | 193 488 |
| Pest control | | - | 1 057 |
| Petrol and oil | | 554 561 | 1 326 905 |
| Repairs and maintenance | | 48 301 | 173 488 |
| Secretarial fees | | 1 000 | 4 399 |
| Staff training | | 36 934 | - |
| Staff welfare | | 23 085 | 39 307 |
| Subscriptions | | 1 327 751 | 782 641 |
| Sundry expenses | | - | 11 634 |
| Telephone and fax | | 556 854 | 934 016 |
| Tender costs | | - | 1 457 173 |
| Travel – local | | 409 800 | 845 483 |
| Travel – overseas | | 336 661 | 544 956 |
| Utilities | | 201 539 | 1 792 418 |
| Validation of lab equipment | | - | 2 895 |
| | | **28 969 949** | **42 767 931** |

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