

Tax Professional

2013 Knowledge Competency Assessment

Paper 1: Solution

Suggested Solutions

Question	Topic	Marks
1	Company Tax Calculation and Advisory	40
2	Analysis of Financial Statements	45
3	Value-Added Tax	25
4	General Tax Principles	50

Total marks: 160

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

Question 1

40 marks

Part A

5 marks

Effect on taxable income:

Gross income – Dividend from Paddington Plc (par (k)) (not Controlled Foreign Company, residents own < 50% of participation rights or voting rights)

- R15.75 (½) / £ x £5 000 (½) x 12% (½) R9 450 (1½)

Exemption – dividend from Paddington Plc – section 10B(2)(a) 2 R9 450 (½)

owns ≥ 10% equity shares and voting rights)

Net income – s 9D – Garfield Plc (a Controlled Foreign Company)

- Garfield is a Controlled Foreign Company, because residents directly hold 45% (36% + 9%) & indirectly holds 6.6% (12% x 55%), thus, jointly 51.6% (which is more than 50%). R290 745 (3)

Thus, net income included = R9.75 / \$ (½) x \$70 000 (½) x 42,6%(36% (1) + 6.6% (1))

Available 5
Maximum 5

Part B

14 marks

To: Mrs Kate Austen – (Director of Fun Blocks (Pty) Ltd)

From: Candidate / Tax Advisor

Reference: Matter 2

Date: xxx

Communications mark / layout / presentation (2)

Dear Mrs Austen,

Fun Blocks leases an allowance / depreciable asset (1) to Robbie Lewis that (4)
was acquired from a connected person (namely Toy Land (Pty) Ltd) of the
lessee (Robbie Lewis) (1). Robbie Lewis and John Hathaway are in terms of
paragraph (c)(i) of the connected persons definition in section 1 of the Income
Tax Act No. 58 of 1962, connected persons as they are partners in a
partnership (1). As both of them are natural persons and they jointly own at
least 20% (they own 33%) (1) of the equity shares and voting rights of Toy
Land (Pty) Ltd, Robbie Lewis is in terms of paragraph (d)(iv) of the connected
person definition, a connected person of Toy Land (Pty) Ltd.

Section 23A is not applicable as the lease is an operational lease (Not clear (1)
from question).

Alt Apply section 23A as this is not operating lease therefore limit section 11
(e) to R3 300 x 12 R39 600

Section 23D is however applicable to the lease as the asset was owned by (½)
Toy Land within 2 years prior to the inception of the lease.

Normal income tax implications:

Gross income: (R3 300 x 12)	R39 600	(½)
Less s 11(e) allowance on moulding machine (calculation 1):	(R186 250)	

Calculation 1

Allowance in terms of section 11(e) read in conjunction with section 23D.		(1)
Allowance on the lesser of:		
(cost price); or	R770 000	
(market value)	R745 000	
Limited to the section 23D cost / value calculated: (see calculation 2)	R753 300	
Thus, allowance = R745 000 (1 principle) / 4 (½)	R186 250	(1½)

Calculation 2

23D cost / value		
Cost price for Toy Land:	R720 000	(½)
Less allowances claimed by Toy Land (1/8/2011 – 1/11/2012):	(R576 000)	(1½)

Calculation 2.1

- ((R720 000 x 40%) + (R720 000 x 20%) + (R720 000 x 20%)) (Section 12C)

Add recoupment for Toy Land: (1 - mark with mistake – must equal allowance claimed)	R576 00	(1)
Add taxable capital gain for Toy Land:	R 33 300	

Calculation 2.2

- ((R770 000 – R576 000) (1 mwm) – (R720 000 – R576 000) (1mwm)) x 66,6% (½)

Consider GAAR 1 bonus mark

Part C

5 marks

Effect on taxable income:

Matter 3

Purchases / manufacturing of building blocks:		(1)
(s 11(a)) 2 000 x R200	(R400 000)	
Section 22(8)(b)(iii) recoupment (market value): 2 000 x R240		(1)
	R480 000	

Matter 4

Capital gains tax event a disposal of land

Proceeds (Market value on 1 Feb 2013):	R270 000	(1)
Base cost:	(R220 000)	(1½)
(R250 000 (½) – R30 000 (1)) (par 12A debt reduction)		
Capital gain:	R 50 000	
Included R50 000 x 66,6% = R33 300 in taxable income.		(½)

Available 5
Maximum 5

Part D

11 marks

Edinburgh Plc

Amount transferred to Edinburgh Plc: 2 000 x R240	R480 000	(1)
↓ in Contributed Tax Capital:		(2)
(30% ^(1/2) x (R120 000 – R25 000) (1)) x 47% ^(1/2)	(R13 395)	
Amount of dividend		
R466 605		
Less: STC-credit (R30 000 (1/2) x (R466 605 / (R466 605 + R254 895))		(1 1/2)
(1 mwm))	(R19 401)	
Amount subject to dividends tax	R447 204	
Dividends tax @ 0% = 0		(1)

Alternative

- Edinburgh Plc is
1. Resident company
 2. Controls at least 10 % of the voting power
 3. Apply 0% in terms of DTA 5.5

Jack Sheperd

Amount transferred to Jack Sheperd:	R270 000	(1)
↓ in Contributed Tax Capital: (30% (1/2)x (R120 000 –		(2)
R25 000)) (1mwm) x 53% (1/2)	R15 105	
Amount of dividend R254 895		
Less: STC-credit (R30 000 (1/2) x (R254 895 / (R466 605 + R254 895))		(1 1/2)
(1 mwm))	R10 599	
Amount subject to dividends tax	R244 296	
Dividends tax @ 15% = R36 644		(1)

Available 11
Maximum 11

Part E

5 marks

In terms of section 104 of the Tax Administration Act No. 28 of 2011(1), Fun Blocks (Pty) Ltd may lodge an objection(1) against the assessment. (2)

The onus of proof will rest on the SARS(1) in terms of section 102 of the Tax Administration Act (½) as the dispute applies to a SARS estimate. (½) (2)

The sales transaction is not an affected transaction(1) in terms of s 31 of the Income Tax Act No. 58 of 1962 (½) as Fun Blocks and the overseas client are not connected persons(1) (although they are respectively a resident and non-resident). (2½)

Fun Blocks had a valid commercial reason to award trade discount as the client is a loyal supporter of the company and the company in any case realised a profit. (1)

It therefore seems that, in all probability, the objection will be successful, which will require SARS to issue a reduced assessment (s 93 of the TAA). (1)

Available 8.5
Maximum 5

Question 2

45 marks

Critically analyse the information provided and identify the possible tax risks.

- The office building was acquired without the taxpayer constructing it (1)
 (acquired from Maverick CC).
 Therefore the commercial building allowance (s13quin) will only be based on (1)
 55% of the cost.
 In addition, the depreciation rate for accounting purposes is 10% whereas (1)
 the tax allowance is 5%.

- The company asset register shows the cost of the Toyota double (1)
 cabs excluding VAT.
 Since a double cab light delivery vehicle is a 'motor car' as defined, (1)
 it appears that input VAT was incorrectly claimed on the purchase. (1)
 The tax allowance (s11e) is also based on the incorrect amount. (1)
 In addition, the depreciation for accounting purposes is 25% whereas and (1)
 the section 11(e) allowance is 20%.

- The Ferrari acquired for use by the directors could constitute excessive (1)
 expenditure.
 The tax allowance (s11e) could therefore be prohibited (1)
 since it could be argued or not expended for purposes of trade (s23g) (1)

- The use of the Ferrari could have normal tax consequences for the directors (1)
 in the form of a fringe benefit for the use of a car.
 Such fringe benefit is subject to employees' tax. (1)
 In addition, Simtech would have to account for VAT output on the right of (1)
 use of the motor car (deemed supply)

- Simtech's intention at the time of purchase is a scheme of profit-making (1)
 therefore the proceeds will be income in nature rather than capital in nature. (1)
 The proceeds will therefore be included in gross income and not taxed as (1)
 a capital gain.

- The loan advanced to Mr Vermeulen gives rise to a deemed dividend for (1)
 dividends tax purposes under s64E(4) as:

 - The loan appears to have been granted to Mr Vermeulen due to (1)
 Mrs Vermeulen's shareholding.
 - Mr Vermeulen is a resident. (1)
 - Mr Vermeulen is a connected person to Mrs Vermeulen (spouse/family (1)
 member) and Mrs Vermeulen is a connected person to Simtech
 (20% interest).
 - The amount of the deemed dividend is the difference between interest at (1)
 6% (the official rate) and actual interest charged (3,5%)
 and the dividend is deemed to have been paid on 28 February 2013 (last (1)
 day of the year of assessment)
 - Such deemed dividend will be subject to dividends tax at a rate of 15% (1)

- PropCo Ltd is a controlled foreign company (CFC) as contemplated in (1)
 section 9D since:

 - It is a foreign company (not a SA resident because incorporated and (1)
 effectively managed in Mauritius)
 - South African residents hold more than 50% of the participation/voting (1)
 rights (Simtech owns 100%).
 - Simtech could possibly be required to include the 'net income' of PropCo in (1)
 its taxable income.
 - The foreign business establishment exclusion could possibly not provide (1)
 relief since PropCo appears to only earn passive rental income (not
 operating company).

- The fact that Alca does not charge interest on the loan could lead to additional taxable income for Simtech: (1)

The fact that interest was not charged could give rise to tax implications: if a quid pro quo is given in return for the interest free loan there could be an 'amount' that would be included in gross income. (1)

The interest free loan was granted in exchange for goods (engines) and therefore the quid pro quo principle established in Brummeria Case and noted in Interpretation Note 58 applies. (1)

If the transaction is seen as a disposal of trading stock out of the ordinary course of business, it could result in a potential recoupment in terms of section 22(8)(b). (1)
- The provision for compensation was posted to the statement of profit or loss and other comprehensive income as an expense. (1)

This expense is not deductible as it has not been actually incurred (s11(a)). (1)

The deduction of expenses capitalised or transferred to reserve funds (including provisions) is prohibited (s23e). (1)
- The purchase price of S390 engines has substantially increased and may not be at arm's length. (1)

The purchase of trading stock by Simtech from Pacific in Hong Kong is an "affected transaction" since: (1)

 - Pacific is a non-resident (incorporated in Hong Kong) (1)
 - Pacific is a connected person to Simtech (owns 20% of the shares). (1)

Transfer pricing provisions will require Simtech to account for the purchases at an arm's length price (s31). (1)
- It appears that Carver (Pty) Ltd is a personal service provider (par 1 of the Fourth Schedule): (1)

 - Services are rendered by a connected person (Alex - shareholder) to the company (1)
 - Services are performed at the premises of Simtech on a daily basis ("mainly at premises") (1)

- Carver (Pty) Ltd does not have any other clients (therefore more than 80% of income if from one client - Simtech) (1)
- Carver (Pty) Ltd does not have any employees (therefore does not have three full-time employees who are not connected persons) (1)
- Payments made to Carver (Pty) Ltd will therefore be subject to employees' tax. (1)
- Prepaid expenditure is not allowed as a deduction (s23H). (1)
 - The telecommunication expenses will be received over five years (therefore not within 6 months) (1)
 - The amount (R120 000) also exceeds R100 000. (1)
 - Therefore only the portion that relates to the 2013 year of assessment (R150 000 x 12/60 = R30 000) will be allowed as a deduction. (1)
- There is a risk that expenses (particularly audit fees) may not be deducted since it was not fully incurred in the production of income (s11(a))/incurred in the production of exempt income (23(f)). (1)
 - The audit fees increased substantially due to audit time spent on testing exempt dividend income. (1)
- Expenditure incurred as a result of unlawful activities is not deductible (s23(o)). (1)
 - The traffic fines incurred by delivery drivers are therefore not deductible. (1)
- Any tax, interest and penalties on taxes that is administered by the Commissioner is not allowed as a deduction (s23(d)). (1)
 - The penalties on late submission of employees' tax returns are therefore not deductible. (1)
- Other valid (1)

Available 56
Maximum 45

Question 3

25 marks

Boogaloo Books (Pty) Limited

VAT RETURN: 1 September to 31 October 2013

Local sales invoiced in - (the amounts reflected below are the amounts debited to the Trade Debtors account in each month) R230 889 (1)

Trade Debtors - (½)

Export sales (zero-rated supply in terms of section 11(1)(a)) - (1)

Interest on overdue accounts ('financial service' – an exempt supply in terms of section 12(a)) - (1)

Bad debts recovered:

- Bonanza Books (R18 500 × 14 / 114) R2 272 (1)

- Stirling Readers (a zero-rated supply) - (1)

Insurance indemnity payment (deemed supply under s 8(8)):

- Stolen trading stock (R120 000 × 14 / 114) R14 737 (1)

- Stolen computers (R80 000 × 14 / 114) R9 825 (1)

- Pool car stolen (not a deemed supply as no input tax credit would have been claimed on its purchase) - (1)

Deemed supply on 'company car' fringe benefit (section 18(3))

(R333 333 (R380 000 × 100 / 114) × 0,3% × 14 / 114 × 2 months) R246 (2)

There is no deemed supply for the overseas air tickets as the trip is not a fringe benefit and the air tickets constitute a zero-rated supply. (1)

Total output tax R257 968

Input tax (Mark correct if input tax is apportioned)

Purchases of trading stock (R1 368 920 × 14 / 114) R168 113 (1)

Trade Creditors - (½)

Salaries and wages (not a 'taxable supply' in terms of the definition of an 'enterprise' proviso (iii)(aa)) - (1)

Fuel (a zero-rated supply in terms of s 11(1)(h)) - (1)

Motor vehicle repairs and maintenance (R3 650 × 14 / 114) R448 (1)

Insurance premiums (R12 000*2 x 14 / 114)	R2 947	(1)
Depreciation (not a 'taxable supply')	-	(1)
Replacement of computers (R120 000 x 14/114)	R14 737	(1)
Purchase of a new pool car		
<ul style="list-style-type: none"> • No input tax credit is available on the purchase of a 'motor car' as defined in terms of section 17(2)(c) 	-	(1)
There is no input tax credit on the hotel accommodation costs as no VAT was charged by the suppliers.		(1)
There is no input tax credit on the subsistence allowance as this is not a 'supply of goods and services' and no VAT is charged thereon.		(1)
Teas and coffees. No input tax credit is available as the expenditure relates to the supply of 'entertainment' as defined (section 17(2)(a))	-	(1)
Rental of office premises (R64 000 x 14 / 114)	R7 860	(1)
Total input tax credits	R194 105	
Net amount of VAT payable to SARS	R63 863	(1)
The VAT 201 return must be submitted to SARS through e-filing by the last business day of November 2013		(½)
If payment is also made through the e-filing system, the latest date to pay the VAT is also the last business day of November 2013.		(½)

Available 26
Maximum 25

Question 4

50 marks

Part A

24 marks

Rental agreement

The onus to prove that the amount is deductible rests with the taxpayer, thus with Better Living (s 102 of the TAA). (1)

An amount can be claimed under section 11(a) if it an expenditure or loss has actually been incurred in the current year in the production of income. (1)

The R10 000 000 spent by Better Living in the current year meets most of the criteria for deduction under section 11 (a). However, it must be determined whether or not the amount is of a capital nature. (1)

Legal categorisation of a payment does not determine whether the payment is of a revenue or capital nature.

OR (1)

The mere fact that the payment constitute rental does not qualify the expenditure as revenue in nature.

(BP South Africa (Pty) Ltd) (1)

Another consideration that the directors of Better Living need to consider is what the purpose was of the expenditure incurred. The reason for this is that the purpose of the expenditure determines the true nature of the expenditure. Each case must be decided on its own facts and circumstances and there is no universal test that will provide for all situations with regard to determining capital or non-capital nature. (1)

- In this case it would seem as if the expenditure that Better Living incurred was for the purpose of acquiring a capital asset for the business, that is, to create an enduring benefit. Better Living will be receiving rental income from the low cost house the tenants rents from them for a period of 20 years. (1)

(African Oxygen Ltd / Palabora Mining / BP Southern Africa / John Cullum / Nchanga / ITC 1036) (1)
 - If the amount is more closely related to the taxpayer's income earning structure (as is the case here), than to its income-earning operations, it will be capital in nature. (1)

(New State Areas / Rand Mines / Cadac Engineering Works / George Forest Timber (creating/acquiring a source of profit = capital in nature) (1)
 - Once and for all expenditure (as is the case here) (and not recurrent) refers to expenditure of a capital nature. (1)

(BP Southern Africa / Stellenbosch Farmers Winery) (1)
- } Max 4

Conclusion:

- The rental expense is therefore not of a revenue nature but is indeed capital. (1)
- A special deduction is however allowed under s 11(f) for a lease premium paid for the right of use or occupation of land or buildings that are used for the production of income in the course of carrying on a trade. (1)
- The amount allowed each year will be the premium of R10 000 000 spread over the period of the lease agreement (1), limited to a maximum of 25 years (1).
- (1).
- The allowance in each year will be apportioned according to the number of months that the property was used as required, therefore in the 2013 year of assessment the apportionment will be determined from the date the property is brought into use through until the end of the financial year. (1)

Royalty agreement

As mentioned above, the reason for the expenditure and its effects need to be looked at.

In the court case BP Southern Africa (Pty) Ltd it was established that certain considerations are important regarding the assessment of capital vs revenue argument. These considerations are:

- The royalties were paid to make use of the trademarks and not to acquire the ownership thereof. (1)
 - The royalties therefore neither created nor preserved any capital asset in the hands of Better Living (1)
 - The fact that the payments are recurring is a strong indicator that the payments are of a revenue nature. (1)
 - the fact that the payment is based on 10% of turnover is a strong indicator of revenue nature (1)
 - In this case it would seem as if the expenditure that Better Living incurred was not for the purpose of acquiring a capital asset for the business, that is, not to create an enduring benefit. The creation of an enduring benefit refers to capital nature. (1)
- } Max 3

(African Oxygen Ltd / Palabora Mining / BP Southern Africa / John Cullum/ Nchanga / ITC 1036) (1)

- If the amount is more closely related to the taxpayer's income earning structure, than to its income-earning operations (as is the case here), it will be capital in nature. (1)

(New State Areas / Rand Mines / Cadac Engineering Works / George Forest Timber (creating/acquiring a source of profit = capital in nature) (1)

- This is a recurrent expenditure and not once and for all which would refer to expenditure of a capital nature. (If mark already awarded above, do not award again) (1)

(BP Southern Africa / Stellenbosch Farmers Winery) (1)

The royalties are not capital in nature based on the above points. (1)

Section 23I specifically disallows the deduction of royalties paid in respect of tainted intellectual property, unless the allowance is granted under s 11(gC); however, the disallowance is not applicable in this scenario as Better Living, or a connected person that is a taxable person, did not develop the IP. (1)

Conclusion:

The deduction under s 11(a) should therefore be allowed. (1)

Maximum 4

Interest-free loans

In order for an amount to be included in gross income, the amount, in cash or otherwise must have received by or accrued to the person that is not of a capital nature. (1)

The issue here is whether or not there is “an amount”. (1)

“An amount” for gross income

If the Commissioner deems that an amount accrues, the onus is on the Commissioner to prove this amount (1)

(CIR v Butcher Bros) (1)

Better Living received an interest free loan from the retired resident and they in return (quid pro quo) received the life right in exchange for their money. (1)

The right to receive to an interest free loan which is not repayable immediately , has a monetary value. (1)

(Brummeria Renaissance (Pty) Ltd.) / Lategan / Delfos (monetary value principle) / Lace Proprietary Mines (monetary value principle) (1)

SARS Interpretation Note No. 58 states that ‘it is evident from the facts of the Brummeria case, that the rights to use the interest-free loans were intended by the lenders (the life-right holders) to be in exchange for the life rights granted by the borrower. (1)

As a result the principles from the judgment may be applied in all cases in which benefits in a form other than money (such as the right to use an interest-free loan) are granted in exchange for goods supplied, services rendered or any other benefit given.

The receipt or accrual in a form other than money could constitute an amount. (1)
Unless this amount is of a capital nature which is not specifically included in the definition of the term “gross income”, it should be valued and included in the gross income of the taxpayer in the year of assessment in which it is received or accrued.

Conclusion:

The value of the receipt or accrual in a form other than money (the right to use an interest-free loan) constitutes an “amount” that “accrues” to Better Living, they received the life right in exchange, and should be included in the gross income of the Better Living in the year of assessment in which the right is received by or accrued to Better Living. (1)

Loan amount

The receipt of money on loan is not gross income as it is capital in nature. The reason is because the receipt is matched by an obligation to repay the amount. (1)

Available 11
Maximum 10

Part B

18 marks

a) Restraint of trade

Restraint of trade payments are not deductible under section 11(a) because of their capital nature (1)

A special deduction is however allowed under section 11(cA) if the payment is taxable in the hands of the recipient, (1)

The deduction will be the lesser of:

The amount divided by the number of years (three and a half, therefore use 4); (½)

or

the amount divided by 3 (½)

Better Living can thus deduct R100 000 per year for four years (from 2012 - 2015) (1)

Available 4
Maximum 4

b) General

The issue for both lump sums is whether the amount is of a capital nature (1) as there is no doubt that there is "an amount, received or accrued, in cash or otherwise" (gross income definition) (1). (2)

It is also clear that the accrual would take place earlier than receipt, as Peter would be unconditionally entitled to the payout (Lategan; Mooi; People's Stores) on the date the court hands down its decision. (2)

Restraint of trade compensation

The restraint compensation is therefore an accrual for the 2013 year of assessment (½), whereas the copyright accrual is included for the 2014 year of assessment (½). (1)

Loss of income compensation specifically places the taxpayer into the same earning position / fills a hole in income as there would have been had the court case not taken place. As income is of a revenue nature and the compensation is designed to put the person in the same position, the conclusion reached is that the amount must be of a revenue nature and therefore 'gross income'. (2)

(WJ Fourie Beleggings / Burmah Steamship) (1)

The restraint amount originally paid (although capital) was included in gross income in terms of paragraph (cA) of the definition of gross income. The compensation ordered by the court, however, is not a restraint of trade payment. While compensation is often of a capital nature, the court specifically awarded the compensation for Peter's loss of income during the court case. (1)

Available 9
Maximum 8

c) Copyright compensation

The court did not make it clear for the copyright case as to the exact nature of the compensation. If the compensation relates to the breach of copyright, the amount would be of a capital nature(1), however if the payment relates to loss of income as a result of the misuse of a copyright, then the outcome would be the same as for the restraint case (revenue nature) (1). (2)

In this particular case, it is also unclear as to whether Peter had actually registered a copyright over the design. (1)

It is submitted that Peter was suing for the use of his design and looking for compensation to restore him to the same position as he was prior to the case (1). That means the compensation sought was for a restoration of the copyright to him (1). This would clearly be of a capital nature (1) and the result would be that the compensation payment for the copyright case would not be 'gross income' (despite accrual in the 2014 year of assessment). (3)

Part C

8 marks

William Smith can be a resident in terms of Ordinary residence, or due to physical presence (S 1 definition of 'resident' as far as it pertains to a natural person). (1)

To determine “ordinary residence”, we need to look at case law.

In the case of Cohen v CIR it was said that a person may have more than one residence, but his ordinary residence will be the country to which he would return to from his wanderings. (2)

In the Kuttel case it was found that ordinary residence was the place where the person was normally resident, apart from temporary absence. (2)

However, William’s secondment is only for 5 years, after which he will return to the US, even though he has settled in and became part of the local community (Interpretation Note No. 3). Thus, SA has not become his real and permanent home. (1)

In terms of the physical presence test, a person is deemed to be resident in South Africa if he has spend more than 91 days in the current AND previous 5 years in South Africa, (and at least 915 in the total in the previous 5 years). A person can therefore only qualify as a resident after the 6th year of meeting the 91-day requirement. (1)

William will only be in SA for 5 years and will therefore not qualify as a resident (1)

Available 8
Maximum 8