

Tax Professional

Knowledge Competency Assessment

June 2014

Paper 1: Question

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	Company Tax Calculation and Advisory	40	Blue
2	Analysis of Financial Statements	45	White
3	Value-Added Tax	40	Pink
4	Tax Administration Act	35	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

Sports World (Pty) Limited (*'Sports World'*) is a South African resident company with a 30 June financial year end. It carries on business as a sports administration company as well as a manufacturer of sporting equipment in Port Elizabeth. The South African Revenue Service ('SARS') considers the manufacturing of sporting equipment as a manufacturing or similar process. The company is not a dealer in shares or instruments and all investments are held with the purpose of generating dividend and interest income.

The company had an assessed loss of R1 200 000 on 30 June 2013. Ignore VAT.

The following information is available for the company:

Sports World (Pty) Ltd
 Draft Statement of Comprehensive Income
 for the year ending 30 June 2014

	Notes	R
Income from providing administration services		10 010 000
Sale of sporting equipment		7 500 000
Cost of sales (sporting equipment)	1	(4 841 900)
Other income		
Interest received	2	99 000
Dividend income	3	?
Lease income	4	80 000
Less: Operating expenses		
Donation	5	(400 000)
Staff costs	6	(7 337 500)
Repairs and maintenance	7	(800 000)
Depreciation	8	<u>(325 286)</u>
Net profit before tax (excluding dividend income)		3 984 314

Notes:

1. Cost of sales

Included in the purchase figure is sporting equipment that was ordered locally as follows:

Order date	Date paid	Delivery date**	Amount
21 June 2014	25 June 2014	15 July 2014	R78 000

***In terms of the purchase agreements that Sports World have with all their suppliers, the risk and benefits of ownership will transfer to the buyer as soon as the goods are delivered.*

2. Interest received

Sports World holds debentures with a face value of R1 800 000 that were issued to the company by Dynamic Sports (Pty) Limited on 1 August 2013. The debentures mature on 31 January 2015 and will be redeemed at a premium of 3% on the face value. The debentures bear interest on the face value at a six monthly rate of 5.5% that are receivable on 31 January and 31 July respectively. The yield to maturity is 6.438293455%.

3. Dividend income

Dividend income is made up as follows:

- A dividend of R100 000 in respect of an investment in the ABC Real Estate Investment Trust on 1 December 2013. This dividend did not constitute an amount contemplated in paragraph (b) of the dividend definition.
- An amount of R80 000 from Admin Wizz (Pty) Ltd on 16 February 2014. Admin Wizz is a South African company in which *Sports World* had purchased a 10% interest in their equity shares for R220 000 on 1 January 2013. The directors of Admin Wizz indicated that 20% of the amount paid to *Sports World* represented a reduction in the company's contributed tax capital. *Sports World* sold 40% of their shares in Admin Wizz for R70 000 on 31 May 2014.

4. Lease income

Sports World owns a 4 000 m² piece of land. The company purchased the land for R1.5 million on 1 July 2012. *Sports World* financed the purchase from surplus cash.

Sports World entered into a lease agreement with Precise Manufacturing (Pty) Ltd ('Precise') on 1 October 2013. The lease agreement determined the following:

- Precise will lease the land from 1 October 2013 for a monthly lease amount of R10 000.
- Precise is obligated in terms of the lease agreement to erect a factory to the value of R950 000 on the land.
- After completion of the factory, an additional monthly lease amount of R15 000 will be payable to *Sports World*, commencing at the end of the month in which the factory is completed.
- Precise will lease the factory for purposes of their own manufacturing business.
- The lease agreement is for a period of 3 years.

The factory was completed on 1 January 2014 and Precise commenced their manufacturing process from that same date. The actual cost of construction totaled exactly R1 100 000. The Commissioner has accepted that the allowance as calculated by *Sports World* is reasonable.

Sports World sold the land and factory to Mr. Kevin Peterson for R3 million on 1 June 2014. Mr. Peterson was entitled to the rental from Precise from June 2014 onwards.

5. Donation

A sporting equipment company supplied free sporting equipment with a market value of R500 000 to *Sports World* on 30 June 2013. *Sports World* donated 80% thereof to local public schools in need of sporting equipment (all the schools are approved Public Benefit Organisations) during August 2013 and obtained the valid receipts for this donation.

The remaining 20% was still in *Sports World's* possession on 30 June 2014. *Sports World's* accountant did not account for the acquisition of the sporting equipment because it was obtained by the company for no consideration.

6. Staff costs

Staff costs includes the following:

- A lump sum of R150 000 was paid to Mrs. Sarah Warner, the spouse of the deceased Mr. David Warner, the former operations manager of *Sports World* on 1 August 2013. Mr. Warner had retired with effect from 1 July 2013 and had been awarded the lump sum on that date to be paid on 1 August 2013. He died on 27 July 2013. The lump sum may only be applied by Mrs. Warner to make contributions to her medical scheme. *Sports World* will retain no further obligation in respect of Mrs. Warner's mortality risks.
- Approved remuneration (salaries plus other fringe benefits) that amounted to R5 750 000. Included in this amount is a payment of R880 000 made to Mr. Glen Maxwell which serves as a restraint of trade payment. Mr. Maxwell was the head of the Sporting Equipment Research Division of *Sports World*. In terms of the restraint of trade agreement, Mr. Maxwell is prohibited to work at a competitor for a period of 4 years from 1 February 2014.
- Contributions that *Sports World* made to an approved Provident Fund on behalf of its employees amounted to R1 437 500 during the year ended 30 June 2014. These contributions are regarded by the SARS as excessive in relation to the value of the services rendered by the employees to *Sports World*.

7. Repairs and maintenance

To ensure similarity and to be in uniform with the new wing (refer note 8.2.) the original administration building was fully retiled at a cost of R800 000 during December 2013.

8. Depreciation

Depreciation was provided for on the following assets appearing on the company's asset register:

Assets	Note	Date purchased	Cost	Depreciation
Manufacturing equipment	8.1	1 July 2012	R555 000	R54 112
Administration building	8.2	?	R6 500 000	R237 588
Land (Administration building)		1 January 2012	R1 300 000	-
Factory	4	?	R950 000	R33 586
Land (Factory)	4	1 July 2012	R1 500 000	-
Total				R325 286

Notes:

- 8.1 Brand new manufacturing equipment was purchased and brought into use on 1 July 2012.
- 8.2 *Sports World* erected and completed an administration building at a cost of R4 500 000 during 2012. A new wing was added to the building during July 2013 and was completed at a cost of R2 000 000 on 30 November 2013. The building is used for the production of administration services income.

Question 1 Required	Marks
	Total
<p>Calculate taxable income/assessed loss of Sports World (Pty) Ltd for the year of assessment ended 30 June 2014 starting your answer with the net profit before tax of R3 984 314.</p> <p><i>Your answer must address each item listed in the Statement of Comprehensive Income.</i></p> <p><i>Provide complete calculations in respect of each item that is adjusted.</i></p> <p><i>Indicate clearly if no adjustment with regards to a specific item is necessary.</i></p> <p><i>Round off all amounts to the nearest Rand.</i></p>	40

Question 2

45 marks

Heath (Pty) Ltd (*Heath*) is a South African resident company with a 30 June financial year-end.

Heath is a distributor of clothing and footwear to local retailers. The company manufactures most of its own fashion lines, but also imports a number of clothing items for local distribution from its holding company, Lombardini SpA, a company incorporated in Italy.

The company also owns a number of commercial properties in South Africa. It also indirectly owns a number of properties abroad through its wholly-owned subsidiary, Lian LLC, a company incorporated in the Mauritius.

Heath's shareholders as at 30 June 2014 were as follows:

Name	Country of Tax Residence	Interest held
Lombardini SpA	Italy	51%
Mr Kindsley	South Africa	22%
Mr Oosthuizen	South Africa	21%
Mrs Clifford	United Kingdom	6%

Mr Kingsley is also the managing director of the company. The company is a registered value-added tax (VAT) vendor. Since it is not a requirement of the Companies Act, the board of directors has elected not to subject the company's financial statements to an external audit.

You are presented with the following financial statements for the year ended 30 June 2014:

Heath (Pty) Ltd
Statement of Profit or Loss and Other Comprehensive Income
for the year ended 30 June 2014

	Note	2014 R	2013 R
Revenue	1	6 750 000	4 000 000
Cost of sales	2	(5 500 000)	(1 900 000)
Gross profit		1 250 000	2 100 000
Other income	3	1 170 000	405 000
Administrative expenses	4	(1 318 000)	(590 000)
Other expenses	5	(1 049 750)	(619 750)
Finance costs	6	(550 000)	(552 000)
Profit (loss) before tax		(497 750)	743 250
Income tax expense		139 370	(208 110)
Profit (loss) for the year		(358 380)	535 140

Heath (Pty) Ltd

Statement of Financial Position as at 30 June 2014

	Note	2014 R	2013 R
ASSETS			
<u><i>Non-current assets</i></u>			
Property, plant and equipment	7	1 846 750	2 346 500
Loan receivable	8	500 000	-
Share investment		160 000	200 000
<u><i>Current assets</i></u>			
Inventory		400 000	130 000
Trade receivables		180 000	25 000
Cash and cash equivalents		1 266 370	120 000
Total assets		4 353 120	2 821 500
EQUITY AND LIABILITIES			
<u><i>Equity</i></u>			
Share capital		1 250 000	1 000 000
Retained earnings		203 120	561 500
<u><i>Non-current liabilities</i></u>			
Loan from Valentino (Pty) Ltd	9	2 000 000	-
Loan from Mrs Clifford	10	-	1 000 000
<u><i>Current liabilities</i></u>			
Trade payables		700 000	250 000
Deposit received	11	200 000	-
Tax payable		-	10 000
Total equity and liabilities		4 353 120	2 821 500

Notes and additional information

1. Revenue consists of:

	2014	2013
	R	R
Gross sales to local customers	7 000 000	4 000 000
Allowance for returns by retailers	(250 000)	-
Total sales	6 750 000	4 000 000

The company’s terms and conditions of sale stipulate that no returns will be accepted. However, in order to maintain good relationships with retailers, the company has an established practice of accepting returns from retailers who have difficulty in selling items. It is estimated that 5% of sales made to retailers will result in returns.

2. Cost of sales was calculated as follows:

	2014	2013
	R	R
Opening stock count	1 100 000	500 000
Direct manufacturing costs incurred	4 000 000	2 000 000
Purchases from Lombardini SpA	1 500 000	500 000
Closing stock count	(1 100 000)	(1 100 000)
Cost of sales	5 500 000	1 900 000

Purchases from Lombardini SpA were translated at an average exchange rate of R14.50: €\$1. Assume the same rate applied through both years of assessment.

3. Other income consists of:

	2014	2013
	R	R
Dividend received from Lian LLC	20 000	20 000
Rental income	150 000	135 000
Consulting fee (refer note 3.1)	-	250 000
Gain on de-recognition of loan (refer note 3.2)	1 000 000	-
Total	1 170 000	405 000

3.1 *Heath* has been assisting a promising new fashion company, Valentino (Pty) Ltd, with establishing its operations from which a consulting fee of R250 000 was earned during the previous financial year. *Heath* agreed not to charge a consulting fee during the 2014 year in exchange for the interest-free loan (refer note 9).

3.2 This gain resulted from the R1 million loan payable being waived by Mrs Clifford (refer note 10). The loan was used to fund general operating expenses of the company.

4. Administrative expenses consist of:

	2014	2013
	R	R
Share-based payment (refer note 4.1)	250 000	-
Salaries and wages	650 000	550 000
Performance bonus (refer note 4.2)	300 000	-
General administrative expenses	75 000	40 000
Penalty for late submission of VAT201 return	43 000	-
Total	1 318 000	590 000

4.1 In order to ensure the retention of his service as managing director, the company’s board approved a share-based payment of 1 000 ordinary shares to Mr Kingsley. The shares were issued on 21 May 2014 and had a market value of R250 000 on this date.

4.2 The company has a policy of paying a performance bonus to the marketing manager if the company’s annual turnover exceeds R4 million. The bonus is equal to 10% of the turnover above R4 million and will be paid during August 2014.

5. Other expenses consist of:

	2014	2013
	R	R
Payment made to health and safety official (refer note 5.1)	20 000	-
Depreciation on factory building (15% per year)	450 000	450 000
Depreciation on office building (5% per year)	49 750	49 750
Cost of erecting billboards (refer note 5.2)	120 000	-
Fair value adjustment on long-term share investment	40 000	-
Year-end function (refer note 5.3)	220 000	10 000
Travel expenses (refer note 5.4)	150 000	110 000
Total	1 049 750	619 750

- 5.1 During a recent inspection of the factory by the Department of Labour, the company was found to be not in compliance with numerous health and safety standards imposed by legislation. Management promised to rectify the health and safety conditions by the end of the financial year and made a payment of R20 000 to an official for not submitting his report to the Department.
- 5.2 Several advertising billboards were erected along the N1 highway at a cost of R120 000 (including VAT).
- 5.3 In order to award the company’s staff for achieving a significant increase in turnover, all members of staff were flown to Cape Town to attend the company’s year-end function. A cost of R220 000 (excluding VAT) was incurred for flights, accommodation, meals and recreational activities.
- 5.4 Travel expenses include R40 000 for the cost of flights and accommodation of Mr Kingsley and his wife on a visit to Lombardini SpA in Italy.

6. Finance costs consist of:

	2014	2013
	R	R
Interest on loan from Mrs Clifford	550 000	550 000
Interest on bank overdraft	-	2 000
Total	550 000	552 000

7. At 30 June 2014, property, plant and equipment consisted of:

	Carrying Amount	
	2014	2013
	R	R
Office building (refer note 7.1)	646 750	696 500
Factory building (refer note 7.2)	1 200 000	1 650 000
Total	1 846 750	2 346 500

7.1 The office building was purchased new and unused for R995 000 on 1 July 2001 and is depreciated over 20 years for accounting purposes.

7.2 The factory building was purchased new and unused for R3 000 000 on 1 July 2010. The building is depreciated for accounting purposes at an annual rate of 15% on cost.

8. The board of directors approved a loan of R500 000 to Ruben Oosthuizen, the son of the shareholder Mr Oosthuizen on 1 April 2014. The loan was repaid on 31 July 2014. Due to Ruben’s prompt repayment of the loan, it was decided not to charge any interest.

9. Valentino (Pty) Ltd advanced this loan to *Heath* on 1 July 2013. Valentino (Pty) Ltd agreed not to charge any interest on the loan in exchange for *Heath* assisting Valentino (Pty) Ltd, a promising new fashion company, with establishing its operations.

10. The loan was advanced by Mrs Clifford, a shareholder, on 1 July 2012. On 30 June 2014, Mrs Clifford announced that she was waiving her right to claim repayment of the capital portion of the loan. The loan was used to fund general operating expenses of the company.
11. Zara CC, a local retailer and customer of *Heath*, placed an order for custom-designed clothing on 25 June 2014 and made a non-refundable deposit of R200 000 into *Heath's* current account. The clothing is expected to be delivered to Zara CC during October 2014.

The Board of Directors has asked you, a registered tax practitioner, to provide a report in which you explain to them the tax implications of each item referred to in notes 1 to 11 above and outline any tax risks that may exist for the company.

Question 2	Marks
Required	Total
List the items that must be included in the report to the Board in response to their request.	45

Question 3

40 marks

This question consists of three unrelated parts.

Part 1

15 marks

Gold's 'n Greens (Pty) Ltd ('GG') is a South African based company that specialises in the importation, processing and distribution of certain exotic fruits. GG is based in close proximity to the Durban harbour, where it leases a warehouse and a small factory. GG is registered as a 'Category B' VAT vendor on the invoice basis.

You are a registered tax practitioner and GG is one of your clients. During the VAT period ended 31 August 2013 GG sent you the following query (all amounts exclude VAT, unless otherwise indicated):

Query

We recently imported 3 000 pounds of frozen Mangosteen fruits from the Sunda Islands in the Malay Archipelago (situated in the Indian/Pacific Ocean area, North of Australia). Please refer to the following invoice we received from World Fruits, Inc. (an American based company) relating to all costs for the importation and purchase of the fruits:

World Fruits, Inc.

INVOICE

Address 21, Westconding street
City, State, ZIP Abilene, Texas, 01232

SOLD TO:

Name Gold's 'n Greens (Pty) Ltd
Address 78 Meiring street
City, State, ZIP Durban, KZN, 0065
Country South Africa

INVOICE NUMBER 536524
INVOICE DATE June 25, 2013
OUR ORDER NO. 726278
YOUR ORDER NO. 1892727
TERMS Net 30
SALES REP Jackie
SHIPPED VIA Sea
FREE ON BOARD No
SALES TAX NR. 45846424664

SHIPPED FROM/TO:

From Sunda Islands, Malay Archipelago
To Durban harbour, South Africa

Sales Tax Rate:

POUNDS	DESCRIPTION	P.P.P	AMOUNT
3 000	Mangosteen fruits, frozen (not for retail)	5,00	\$15 000,00
		SUBTOTAL	15 000,00
		TAX	0,00
		FREIGHT	3 000,00
			\$18 000,00
			PAY THIS AMOUNT

THANK YOU FOR YOUR BUSINESS!

Upon the arrival of the Mangosteen fruits in the Durban harbour we paid World Fruits, Inc. an amount of R178 560 (the rand/dollar exchange rate on that day was R9.92 = USD1). The fruits will be applied for the following purposes:

- 1 000 pounds (454 kilograms) of the fruit will remain frozen and will be sold and transported to various fruit retailers in Durban. We have already received all the orders for the fruit from the retailers and are therefore in the process of creating invoices for their orders. We will make use of our own trucks in transporting the fruit and will sell the fruit at R200 per kg. In transporting the goods we have calculated that the total amount received for transportation will be R11 350 and petrol costs of R8 500 will be incurred.
- 1000 pounds (454 kilograms) will be juiced and mixed with a sugar-water solution. The juice will be pumped into 100-litre containers and sold to retailers at R5 000 per container (of which R25 goes to recovering the cost of the container, but this is not separately shown on the invoice). We already have orders for 3 000 litres of juice and

send out the invoices to the retailers. The amount that will be received for transporting this order is R12 500 and petrol costs of R9 200 will be incurred.

- 1000 pounds (454 kilograms) of the fruit will be crushed and the pulp will be sold to jam manufacturers at R250 per kg. The process of pulping the fruit ensures the preserving of the fruit in its natural state. The orders for these supplies have also been received and we are in the process of creating invoices. Due to difficulties in transporting large quantities of pulp, we do not offer transportation of the pulp as a service and the retailers are required to arrange for transportation at their own cost.

We are unsure about the VAT consequences of the importation and sale of the fruit, also the amount of input tax and output tax that we should account for. Further, when do we account for these taxes as we have not received any payment from the buyers? A friend that is an auditor has referred us to section 13(3) of the VAT Act, but we remain uncertain.

<p>Question 3 Part 1 Required</p>	<p>Marks</p>
<p>Explain the VAT consequences and treatment of the importation and sale of the fruit. <i>Support your explanation with calculations where appropriate.</i></p>	<p>15</p>

Part 2

15 marks

Auto Zone (Pty) Ltd (*'Auto Zone'*) is a registered category B VAT vendor on the invoice basis, buys and sells second hand motor vehicles (70% of the turnover of the business) and also supplies, in the course of a taxi-transport business, transport to fare paying passengers and their personal effects (30% of the turnover of the business). *Auto Zone* rents a show room located in Hatfield, Pretoria and started trading during the 2009 year of assessment.

On 15 February 2013 the following information applies to *Auto Zone*:

- The open market value of all the second hand vehicles, purchased and used for the purposes of selling, owned by *Auto Zone* amounts to R2 800 000. The cost of motor vehicles bought from vendors amount to R1 200 000 (including VAT) and the cost of motor vehicles bought from non-vendors amount to R1 300 000.
- On the second hand motor vehicles purchased from vendors, for the purposes of selling, *Auto Zone* still owes creditors R800 000 (including VAT). R500 000 of this debt is older than 12 months and the remaining R300 000 is not older than 12 months.
- *Auto Zone's* debtors account, only relating to the supply of the second hand motor vehicles, amounts to R465 000. None of this debt owed to *Auto Zone* is older than 3 months and none is expected to be written off.
- The open market value of the taxi's, purchased and used for the purposes of the taxi-transport business, amounts to R900 000. All the taxis were bought by means of cash purchases from vendors at a total cost of R950 000 (including VAT).
- *Auto Zone* also purchased a number of vehicles as company vehicles (all motor cars as defined), for solely business use by the directors of *Auto Zone*. The open market value of these vehicles amount to R750 000 and the cost of these vehicles amount to R850 000 (including VAT).

During the last 12 months, before 15 February 2013, the total taxable supplies by *Auto Zone* significantly decreased to R765 000 and *Auto Zone* is therefore considering one of two possibilities:

1. Deregister as a VAT vendor on 15 February 2013, but keep the business. (8)
2. Supply the entire business as a going concern to Auto One (Pty) Ltd ('Auto One') (not a connected person and a VAT vendor) for a total consideration of R4 000 000. Both parties will agree in writing that the supply should be zero-rated, will be an income earning activity at the time of the conclusion of the contract and all the assets necessary to carry on the enterprise (including the taxi transport business assets and the company vehicles) will be supplied. All vehicles will be used in the exact same manner as used by *Auto Zone*. (7)

Question 3 Part 2 Required	Marks
<p>Calculate, supported by brief reasons and legislation, all the VAT consequences for each of the two possibilities considered by <i>Auto Zone</i>. For the second possibility also consider the VAT consequences for <i>Auto One</i>.</p> <p><i>You may assume that no vehicles were purchased from connected persons and that all the necessary documents have been obtained.</i></p> <p><i>Round off all amounts to the nearest Rand value.</i></p>	15

Part 3

10 marks

Deli Doughnuts (Pty) Ltd (*'Deli Doughnuts'*), a resident company and registered as a category A, invoice basis VAT vendor, supplies various baked goods and beverages. *Deli Doughnuts* is the wholly owned subsidiary of Good Foods (Pty) Ltd (*'Good Foods'*), a company with its head office in the United States of America and various branches around the world, including South Africa.

Deli Doughnuts follows a strict policy whereby any baked goods that are not supplied during the day of baking may not be sold in the *Deli Doughnuts'* shop and should be sold in another manner.

During the VAT period ended on the last day of March 2013, *Deli Doughnuts* sold 300 doughnuts to a *Good Foods* branch in South Africa for a total consideration of R300. *Good Foods* always give the doughnuts, which they buy from *Deli Doughnuts*, away for no consideration to a children's day-care centre (not recognised as a public benefit organisation) in Johannesburg as part of their corporate social responsibility. This is done every second day by *Good Foods*. The open market value of the doughnuts sold to *Good Foods* amounts to R1 200.

Question 3 Part 3 Required	Marks
<p>Discuss with reference to legislation, the total amount of output tax payable by <i>Deli Doughnuts</i> relating to the doughnuts sold to Good Foods.</p> <p><i>Calculations may be used to support your discussion.</i></p> <p><i>Assume that Deli Doughnuts claims a 100% input tax deduction on all acquisitions relating to the supply of doughnuts.</i></p> <p><i>Deli Doughnuts makes more than 95% taxable supplies.</i></p> <p><i>Round off all final amounts to the nearest Rand value.</i></p>	<p>10</p>

Question 4

35 marks

Your name is Sylvia Healy and you completed your Honours degree in Taxation five years ago. You are the only shareholder, director and employee of Syltax (Pty) Ltd ('*Syltax*'), a company that provides tax services including the submission of tax returns to the South African Revenue Service ('SARS') on behalf of clients and furnishing tax opinions.

Nick Mollin, a friend from your university days, is now the financial director of TH Properties (Pty) Ltd ('*TH*'). *TH* owns a number of residential properties in Hatfield, Pretoria. All properties are acquired for the purpose of renting them out to students.

As financial director, Nick is responsible for submitting the tax returns of *TH* and attending to the tax affairs of the company and its subsidiaries. However, Nick has approached your company, *Syltax*, for assistance with the tax matter detailed below:

- Two years ago, *TH* was presented with the opportunity to acquire 100% of the shares of StuProps (Pty) Ltd ('*StuProps*') for R15 million. *StuProps* also owns residential properties in Hatfield with an original cost of R10 million (acquired after 1 October 2001) and a market value of R15 million at the time. *StuProps* has no liabilities.
- *TH* did not have any cash reserves available and did not want to sell any of its current properties to raise sufficient capital to buy the shares in *StuProps*. The company therefore had no option but to raise loan finance from a bank (which it could easily do due to the large number of properties available as collateral).
- However, Nick Mollin was aware that the interest on such loan would not be deductible for tax purposes by virtue of section 23(f) as it is in the production of exempt income (the shares would produce local dividend income which is exempt from normal tax).

Nick decided to structure the transaction as follows:

- A new company called Newco (Pty) Ltd ('Newco') will be incorporated and TH will own 100% of its shares.
- Newco will purchase properties from TH with a market value of R15 million. Newco will finance this purchase by obtaining a mortgage bond from local banks at a rate of 9% per annum (therefore interest of R1.35 million per year).
- The properties that Newco acquired from TH will earn rental income of R1.4 million per year.
- TH will use the R15 million raised to buy the shareholding in StuProps.
- After ten years, TH will repurchase the properties sold to Newco for R15 million. Newco will then use the R15 million to settle the mortgage.
- The original sale of the properties to Newco and the repurchase ten years later will not have any capital gains tax consequences for either party, as the corporate roll-over for intra-group transactions in section 45 of the Income Tax Act will be used.
- The transaction will effectively allow TH to shift R1.4 million of its income to Newco and Newco will be able to deduct interest of R1.35 million on the bond leaving only R50 000 in taxable income per year. The transaction means that TH effectively retains ownership of all existing buildings (either directly or via its 100% shareholding in Newco) and that the group will effectively be able to deduct the interest incurred to acquire the shares in Hoffman.

All companies referred to above have a 31 December financial year-end.

Nick submitted the tax returns of TH, StuProps and Newco on 10 March 2014. SARS issued assessments for each return on 11 March 2014.

The assessment for Newco indicated tax payable of $28\% \times R1.4 \text{ million} = R392 \text{ 000}$ and that the R1.35 million in interest incurred had been disallowed as a deduction.

Nick filed a notice of objection on 12 March 2014 and received correspondence from SARS on 20 March 2014 that the objection had been disallowed.

Question 4 Required		Marks	
		Sub- total	Total
a	Discuss whether the transaction detailed above constitutes a 'reportable arrangement' as defined in the Tax Administration Act, 2011. <i>You are not required to consider whether it is an excluded arrangement as contemplated in section 36 of the Tax Administration Act.</i>	12	35
b	Assuming that a reportable arrangement exists, identify who must report it and the period within which it must be reported to SARS. List the information that is required to be disclosed to SARS. Also indicate the type and amount of penalty that would be imposed if it is not reported.	10	
c	Explain all further dispute resolution mechanisms available to <i>Newco</i> .	9	
d	Discuss whether any of the natural persons and companies mentioned above are required to register as tax practitioners.	4	