Professional Level – Options Module

Advanced Taxation (South Africa)

Friday 9 December 2011

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

Tax rates and allowances are on pages 2–4

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.
This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants

Paper P6 (ZAF)

ACCA

SUPPLEMENTARY INSTRUCTIONS

1. You should assume that the tax rates and allowances for the tax year 2011 will continue to apply for the foreseeable future unless you are instructed otherwise.
2. Calculations and workings need only be made to the nearest R.
3. All apportionments should be made to the nearest month.
4. All workings should be shown.

TAX RATES AND ALLOWANCES

The following tax rates and allowances are to be used in answering the questions.

Year ended 28 February 2011/31 March 2011

Rebates	
Primary rebate	R10,260
Secondary rebate (over 65)	R5,675
Interest exemption	
Under 65	R22,300
Over 65	R32,000
Medical contribution rates	
Single member	R670
Member plus one dependant	R1,340
Each subsequent dependant	R410
Companies	
Normal tax rate	28%
STC rate	10%
Trusts (other than a special trust)	40%
Donations tax	20%
Estate duty	20%
Official interest rate (assumed)	12%

Rates of normal tax
payable by persons (other than companies)
in respect of the year of assessment ended 28 February 2011

Where the taxable income	
does not exceed R140,000	18% of each R1 of the taxable income
exceeds R140,000 but does not exceed R221,000	R25,200 plus 25% of the amount over R140,000
exceeds R221,000 but does not exceed R305,000	R45,450 plus 30% of the amount over R221,000
exceeds R305,000 but does not exceed R431,000	R70,650 plus 35% of the amount over R305,000
exceeds R431,000 but does not exceed R552,000	R114,750 plus 38% of the amount over R431,000
exceeds R552,000	R160,730 plus 40% of the amount over R552,000

Tax rates
for small business corporations
for the year of assessment ending 31 March 2011

R0 – R57,000	Nil
R57,001 – R300,000	10% of the amount over R57,000
R300,001 and above	R24,300 plus 28% of the amount over R300,000

Turnover tax rates
for micro business corporations for the
year of assessment ended 28 February 2011

R0 – R100,000	Nil
R100,001 – R300,000	1% of the amount over R100,000
R300,001 – R500,000	R2,000 + 3% of the amount over R300,000
R500,001 – R750,000	R8,000 + 5% of the amount over R500,000
R750,001 – R1,000,000	R20,500 + 7% of the amount over R750,000

Capital gains tax

Annual exclusion	R17,500
Primary residence exclusion	R1,500,000

(where proceeds are R2 million or less, the full gain is excluded for the portion of the property used for domestic purposes as a primary residence)

Inclusion rate (natural persons)	25%
Inclusion rate (non-natural persons)	50%

Time apportioned base cost formula: $Y = B + \left[\frac{(P - B) \times N}{(T + N)}\right]$

Travel allowance table
for years of assessment commencing on or after 1 March 2008

Value of the vehicle (including VAT but excluding finance charges or interest)	Fixed cost	Fuel cost	Maintenance cost
R	R p.a.	c/km	c/km
0 – 40,000	14,672	58·6	21·7
40,001 – 80,000	29,106	58·6	21·7
80,001 – 120,000	39,928	62·5	24·2
120,001 – 160,000	50,749	68·6	28·0
160,001 – 200,000	63,424	68·8	41·1
200,001 – 240,000	76,041	81·5	46·4
240,001 – 280,000	86,211	81·5	46·4
280,001 – 320,000	96,260	85·7	49·4
320,001 – 360,000	106,367	94·6	56·2
360,001 – 400,000	116,012	110·3	75·2
Exceeds 400,000	116,012	110·3	75·2

Notes:
Where reimbursement is based on actual business kilometres travelled and no other compensation is paid to such employees and the kilometres travelled for business does not exceed 8,000, the prescribed rate is R2·92 per kilometre.

Tax rates
of normal tax retirement lump sum benefits
in respect of the year of assessment ended 28 February 2011

Not exceeding R300,000	0% of taxable income
Exceeding R300,000 but not exceeding R600,000	18% of each R1 of the taxable income exceeding R300,000
Exceeding R600,000 but not exceeding R900,000	R54,000 plus 27% of the taxable income exceeding R600,000
Exceeding R900,000	R135,000 plus 36% of the taxable income exceeding R900,000

Tax rates
of normal tax withdrawal lump sum benefits
in respect of the year of assessment ended 28 February 2011

Not exceeding R22,500	0% of taxable income
Exceeding R22,500 but not exceeding R600,000	18% of each R1 of the taxable income exceeding R22,500
Exceeding R600,000 but not exceeding R900,000	R103,950 plus 27% of the taxable income exceeding R600,000
Exceeding R900,000	R184,950 plus 36% of the taxable income exceeding R900,000

Rating formulae

$$R = \left[\frac{F}{B + D - (C + L + G)} \right]$$

$$Y = \left[\frac{A}{B + D - (C + L)} \right] \times (B - L) + (L \times R)$$

Section A – BOTH questions are compulsory and MUST be attempted

1 Poseidon Ltd is a South African resident company engaged in the fishing industry. During the year, the company entered into a number of transactions. The audit team would like to review the tax consequences of the transactions below to ensure that these transactions have been accurately and completely recorded. It must be noted that fishing is not considered to be a process of manufacture.

Transaction for the period 1 April 2010 to 31 March 2011:

(i) Poseidon Ltd acquired a new fishing vessel to operate in terms of its commercial fishing licence. The vessel cost R6,840,000 (including VAT) on 1 April 2010. After a few months at sea, the directors of Poseidon Ltd decided (on 1 November 2010), as part of their social responsiveness programme, to use this vessel 50% for commercial fishing and 50% for the 'Sea Patrol' (a local organisation engaged in teaching safety at sea to under-privileged youths). The market value on 1 November 2010 was R6,150,000. The Commissioner allows fishing vessels to be written off over 12 years for Income Tax purposes.

(ii) Poseidon Ltd ran a 'fish and chips' canteen for its staff. One staff member asked to buy the business as a going concern and to lease the floor area of the existing premises in which the canteen was housed. The staff member bought the business as a going concern from Poseidon and began leasing the floor area. The staff member who bought the business was not at the time of acquisition (nor is currently required to be) registered for value added taxation (VAT). The auditors would like to check in particular whether or not the company was correct in zero rating the sale for VAT purposes. The agreed sale price (at the zero rate) was R1,500,000 and included all equipment necessary to run the canteen as at 1 June 2010. The company also agreed to not charge VAT on the lease of floor space (being monthly payments of R10,000).

(iii) The company has a separate administration office, away from the fish processing plant. This office is also used to host client meetings. The building is owned by the company and includes not only the administration offices, but also residential apartments. During the year, the company had to replace an elevator (lift) in the building. The elevator was replaced as part of the modernisation of the building (i.e. was not a repair). The new elevator is more energy efficient and faster than the older model.

The new elevator was imported on 1 June 2010 at a cost of R750,000, in addition to which customs duty of R150,000 was levied. The building use has been consistent since acquisition on 1 October 2007, being 70% for commercial purposes (administration offices) and 30% for residential accommodation. The building originally cost R5,700,000 (including VAT) and was bought used.

(iv) The building (in (iii) above) was sold on 1 December 2010 for the tax invoice value of R14,000,000 (its market value), of which half was paid on 1 December 2010 and the other half on 1 April 2011. The audit team is satisfied as to the income tax considerations, but requires advice on the VAT considerations for this transaction only.

Required:

In the form of a memorandum:

Advise the audit team of Poseidon Ltd as to the tax implications of the above transactions. (32 marks)

Professional marks will be awarded in question 1 for the appropriateness of the format and presentation of the memorandum and the effectiveness with which the information is communicated. (3 marks)

(35 marks)

2 Capt Davey Jones is 55 years of age. Hard work as a merchant navy captain, and now ship owner, has allowed him to build up significant personal wealth.

Capt Jones recently had a severe health scare and would now like to set up an estate plan to cater for his wife, Nautica (53 years of age), and their two children, Matey (a son aged 24) and Calipso (a daughter aged 17).

Capt Jones has most of his wealth in long-term assets, being property and equity investments. Current valuations have the property portfolio at a total value of R35 million and the equity investments at R15 million.

A friend of Capt Jones suggested he do one of the following:

(i) Donate all of his assets to his wife.
(ii) Donate a usufruct in his assets to his wife and retain the bare dominion. The bare dominion will then be left to his two children in his will.
(iii) Form a trust in which his wife and children are beneficiaries and of which Capt Jones could decide to become a trustee. Capt Jones would either donate or sell his assets to the trust.

Required:

Draft a letter to Capt Jones comprehensively addressing the tax implications of each of the above options (i) to (iii). Your letter should conclude by offering a recommendation to Capt Jones as to which of the three options is preferable, giving brief reasons. (23 marks)

Professional marks will be awarded in question 2 for the appropriateness of the format and presentation of the letter and the effectiveness with which the information is communicated. (2 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

3 A client, Exchange Data Ltd, is a JSE Stock Exchange listed South African resident company. It provides a service to stock brokers and traders in South Africa of live streams of data concerning share prices from stock exchanges around the world.

Issue 1:

On 1 April 2010, Exchange Data Ltd concluded a contract with a United Kingdom (UK) based company to exclusively use the UK system to supply the worldwide data to the Exchange Data Ltd customer. The agreement, which is to last five years, provides that Exchange Data Ltd must:

1. Pay R5 million annually for the system licence, which enables Exchange Data Ltd to decode and transmit the data from the UK company's systems;
2. Pay R2 million annually for the licence to sell the data accessed via the system to Exchange Data Ltd's own customers;
3. The full price for the five years of R35 million (being R5 million x 5 years plus R2 million x 5 years) is payable in advance, due to the UK company's concerns about future Rand–GBP volatility if the price was to be paid in instalments;
4. The price is to be settled by the issue of R12 million worth of shares (representing 24% of the issued equity capital of Exchange Data Ltd) and a loan account in favour of the UK Company of R18 million.

Before reaching this agreement, Exchange Data Ltd had used multiple service providers in order to obtain stock exchange data from around the world, paying around R8 million per annum for these services. The R8 million per annum had been permitted by the Commissioner as a general deduction.

Issue 2:

Exchange Data Ltd owns a large tract of land on which the company had intended to develop large warehousing for its servers. Due to housing pressures from encroaching suburbs, the company wishes to sell the land. It would like to understand, briefly, the differences (i) between selling the land directly itself to the local municipality or (ii) forming a 'realisation company' to sub-divide, develop infrastructure (service pipes, roads etc) and market for sale as separate erven to prospective homeowners.

If the realisation company is formed, its sole mandate will be to realise the land disposal within one year to best advantage. The rationale for the formation of a realisation company would be to remove aspects not related to the core business of Exchange Data Ltd.

Required:

(a) Advise whether or not (or to what extent) the R35 million price paid for the licences over five years (Issue 1) may be deducted by Exchange Data Ltd in arriving at its taxable profits for the year ended 31 March 2011. (13 marks)

(b) Briefly advise Exchange Data Ltd as the income tax effects of the sales of land in terms of the two options of land realisation for itself and, for option (ii), the realisation company. (7 marks)

(20 marks)

4 Lease Co Ltd ('the company') is a South African resident company and value added tax (VAT) vendor. The company engages in the sale and leasing of manufacturing machinery to South African customers. All the customers acquiring these machines use the machines in processes of manufacture. Selected transactions for the year ended 31 March 2011 are provided below.

Instalment sales

The manufacturing machinery is a standard product and has the same terms for each instalment sale. Analysis of only a single contract is therefore necessary. Each machine is bought, for cash at a cost (including VAT) of R1,938,000, by the company for resale on instalment terms to its customer.

Each contract has the following terms:

(i) The machine has a cash selling price (including VAT) of R2,280,000.
(ii) An initial deposit of R300,000 is payable on concluding the agreement and is treated as part payment of the total consideration.
(iii) The monthly instalments of R44,044 in arrears are payable for a period of five years.
(iv) The monthly yield to maturity is 1%.
(v) On conclusion of the agreement, the machine is immediately delivered to the customer.
(vi) The Commissioner has agreed that any debtors allowance is to be based on a gross profit percentage on sales.

One such sale took place on 1 April 2010.

Leasing

Each lease also has standard terms. The company does not contract with connected persons. Each lease had the following terms:

(i) The cash value (including VAT) of the machine leased is R2,280,000.
(ii) The monthly cash payment in terms of the lease agreement is R68,000 for three years.
(iii) The residual value in terms of the lease is R800,000.
(iv) If the lessee wishes to acquire the leased asset at the end of the lease, it is sold at such residual value.
(v) Market value of the machine at the end of the lease is estimated at R850,000.

One such lease ended on 31 October 2010 and the lessee purchased the machine for its residual value in terms of the lease agreement. Lease Co Ltd had specifically acquired the machine new, at a cost of R1,938,000 including VAT, for the purposes of this lease. In addition, the lessee had used the asset in a process of manufacture for the full duration of the lease.

The SARS practice (i.e. this is not in terms of legislation) of adding output VAT in terms of the lease to the cost for the purposes of determining the Lease Co Ltd allowance is not adopted by Lease Co Ltd.

Required:

(a) Explain and calculate the tax implications for Lease Co Ltd of one instalment sale arrangement concluded on 1 February 2011 for the year ended 31 March 2011. (8 marks)

(b) Explain and calculate the tax implications for Lease Co Ltd for the year ended 31 March 2011 of the finance lease arrangement that ended on 31 October 2010. (12 marks)

(20 marks)

5 ABC Ltd (the company) has approached you for advice on an employee share scheme. The scheme does not qualify as a broad-based share plan.

The company intends implementing a limited period employee share scheme (the Scheme), in terms of which qualifying employees of the company will be beneficiaries in a Trust to be created for the purpose of the scheme. The residual beneficiary of the Trust is ABC Ltd's holding company (Hold Co Ltd). All parties to the scheme are resident in South Africa. The scheme and the shares issued thereunder will not result in Hold Co Ltd losing its controlling shareholding in ABC Ltd.

(i) The qualifying employees will become beneficiaries in the Trust with vested capital rights at the inception (the effective date) of the Scheme to a specified number of ordinary shares (ABC Ltd shares) that will be issued by the company to the Trust on the effective date.

(ii) The qualifying employees will, as from the effective date, have limited vested income rights to a percentage of all ordinary dividends (dividends) paid by the company to the Trust in respect of the company shares in which they hold vested capital rights. The dividend income, over which the Trustees have discretion, will be retained by the Trust.

(iii) In terms of the proposed Trust Deed the qualifying employees will not be entitled to, *inter alia* –

(a) dispose of, pledge, cede in security, mortgage or otherwise hypothecate or encumber any of their vested rights; or

(b) dispose of any company share which has been distributed to them in terms of the Trust Deed until after the expiry of a period of seven days from the distribution date.

(iv) The vested rights granted to the qualifying employees are subject to the employees remaining in the employment of the company for the period the Trust exists. Thus, if a qualifying employee resigns or is dismissed, he/she forfeits all of his/her vested rights. Such forfeited rights are held as discretionary assets in the Trust to be distributed to the residual beneficiary (Hold Co Ltd) on termination of the Trust, along with any capital gain arising on such distribution.

(v) The company shares to which a qualifying employee is entitled may only be distributed after ten years (the final date) from the effective date. However, the board of directors of the company will be entitled to determine an earlier final date.

(vi) The company will repurchase the company shares held by the Trust on the final date at market value, if the market value is below that value on the effective date. The possibility may exist that the company will repurchase all of the shares which were acquired by the Trust on the effective date.

(vii) At the final date, should the company not have to repurchase the shares (i.e. where the market value is higher than the effective date value), the shares will be distributed to the qualifying employees (still subject to point (iii)(b) above). All remaining assets (for example, retained dividend income) will be distributed to the residual beneficiary (Hold Co Ltd) and the Trust will terminate.

Required:

(a) Advise ABC Ltd as to the current and future tax implications for the employees under the scheme. (14 marks)

(b) Advise the Trust and Hold Co Ltd on any current and future tax implications which the scheme will have for them. (6 marks)

(20 marks)

End of Question Paper