



Examiner's report

P6 Advanced Taxation (ZAF)

December 2011

General Comments

The examination consisted of two compulsory questions (Question 1 for 35 marks and Question 2 for 25 marks). Candidates had to then elect any two of the three questions in Section B (each for 20 marks). The examination required mainly discussion and advice with some computation as well.

There were observable gaps in knowledge based on the answers supplied. These are highlighted below.

Candidate's answers to discussion questions, in some cases, tended to be repetitive and indicate that those candidates had not fully grasped or considered all of the issues on the topic.

The paper did not appear to cause any time constraint difficulties as most candidates attempted the necessary questions.

Specific Comments

Question One

Question 1 required candidates to provide advice in the form of a memorandum.

The memorandum had to address various transactions, specifically:

1. Acquisition of a capital asset and subsequent change in use;
2. Review of VAT consequences of a "going-concern sale" and an operating lease;
3. A capital asset acquisition for mixed supply purposes (and which attaches to a permanent structure);
4. Disposal of an asset used in mixed supplies.

Many of the marks allocated to this question, and indeed the emphasis, was on VAT. Some candidates interpreted the requirement narrowly. "Tax consequences" refers to all taxes and not merely income tax. Unsuccessful candidates should review their answers for such mis-interpretation.

(1) Most candidates scored the marks allocated to the acquisition of the asset and the immediate VAT input claim. In addition, most recognised that the change in use would have an effect on the income tax allowance claimed on the asset. The question clearly indicated that fishing was considered to NOT be a process of manufacture, yet some candidates insisted on applying "process of manufacture" capital allowances. No credit could be awarded where candidates took this approach. Despite the above "good" points, many candidates either ignored or had not studied the VAT change of use adjustment implications. This is a critical and regularly used VAT function and should be well understood. Some candidates recognised that there would be an adjustment but did not know how to determine the effect.

(2) Candidates recognised that the going-concern effect had to be tested. The question specifically stated: "The auditors would like to check in particular whether or not the company was correct in zero rating the sale for VAT purposes". It was apparent that many candidates did not study one of the fundamental requirements for a going-concern sale at the zero rate, namely that both the buyer and seller must be VAT vendors. Many candidates stated that it did not matter that the buyer was not a VAT vendor in contradiction to the VAT Act. Even those candidates that correctly identified that the zero-rating was incorrect, did not identify the consequences of the incorrect treatment, specifically that penalties and interest on the outstanding VAT output may be applied. However, most candidates did correctly identify that the lease was a taxable supply and VAT should be charged, but again omitted the consequence for this having not been done.

(3) Issues specific to this part included:

- That the new elevator did not represent a separate asset (become part of the building)
- Was an improvement to the building
- That the building did not qualify for allowances but the elevator did

- The VAT effect for imported goods
- Apportionment of the input VAT claimed as the elevator was used for mixed supplies

Generally candidates identified the first two bullet points, but did not identify the remaining effects. In particular, VAT appears to be a general weakness.

(4) Critical to this part was that the output VAT on the disposal of the building must be based on the full sales price (i.e. the output VAT does not take into account that the input was only a partial claim as the building was used for mixed supplies). However, an input VAT adjustment may be made. The basis for the input VAT adjustment appears to be a knowledge gap (when identified). Many candidates adjusted the output VAT which is simply incorrect.

The major difficulties in the question appear to be:

- (a) gaps in candidate knowledge – this can be rectified by additional study material and practice questions
- (b) a lack of focus in answering questions – this can be rectified by candidates having test and practice questions marked (having been completed under examination conditions).

Question Two

This question, in the form of a letter, addressed a number of estate planning options, namely:

1. Donation of assets to the spouse
2. Donation of a usufruct to the spouse and bare dominium to children on death
3. Formation of a trust and transfer of the assets by donation or sale

Critical to part (1) was the identification that no donations tax would be levied on transfer of assets to the spouse by donation and that the capital gains tax effects would be subject to roll-over. Many candidates identified either of the options, but generally not both. Alternatively candidates indicated that donations tax and capital gains would be levied (which is incorrect). Finally the candidates did not consider the advantages and disadvantages of each plan, which largely relates to the control of the assets. This critical aspect is not tax knowledge per se, but rather important to the provision of tax advice. Finally few candidates addressed the issue that the tax consequences are merely transferred to the surviving spouse (mainly through failure to identify the exemption and roll-over effects).

Part (2) provided new considerations. Most candidates were aware of the difference between a usufruct and bare dominium and the consequences thereof. However, few to no candidates considered the advantages or disadvantages to this option. No candidates were able to identify the final large capital gains implication for the children in the future of such a plan.

The third part (formation of a trust) should have been well-handled, but was not. Trust questions occur regularly in examinations as the implications address both planning, advice, and technical knowledge. Many candidates were repetitive in this solution (repeating effects for all three parts). While some candidates addressed sale on loan account, some suggested outright sale to a newly formed trust without considering the obvious flaw in their plan (i.e. getting cash into the trust to buy the assets). Those candidates that identified the usual planning approach of using interest free loan accounts did not extend the thinking to the potential limitation of attribution where this sale mechanism is applied (versus donation). Candidates also did not address the advantages or disadvantages that this approach would have on an estate plan (the main focus of the question).

Repetition can be avoided by referring to earlier parts (particularly where the effects are the same or similar). Additional considerations or differences can be highlighted in the later parts without repeating all the consequences considered earlier.

Candidates should also focus on the main theme of the question and then consider the component parts in relation to that theme. In addition, practical considerations should be borne in mind when considering estate plans in particular.

Key tip to candidates: Avoid stating irrelevant information. In this question, two classes of property (all classified as “investment” in the question) were provided. Clearly, the primary residence is not amongst this property and therefore does not require discussion. Many candidates had almost a page long discussion on the primary residence effects for the various estate plans, which had no bearing on the answer.

Question Three

This question had two parts

Part (a) considered the deductibility of expenditure incurred (specifically the issue of capital versus revenue) and tested the ability of candidates to unpack a real-world scenario and analyse it against one of the fundamental deduction provisions. Part (b) considered the gross income concept, particularly the capital versus revenue issue within the definition.

For part (a), some candidates completely missed the issue, getting caught up in discussion related to the 24% acquisition and considering thin capitalisation. Such candidates failed to discuss the deductibility of the expenditure (which was not interest on the loan and therefore not a thin capitalisation issue).

Candidates generally did well in part (b). Most understood that for the first option, a capital gain would be realised and for the second option, the intention changed to one of a profit-making scheme.

Areas for improvement by candidates for this type of question includes the following:

- State the obvious – candidates often omitted reference to the key concept under discussion. For example, in part (a) candidates should have indicated that the issue was that of deductibility of the expenditure incurred and that the general deduction section should be considered (which provides ... etc.). In part (b) a similar obvious statement should be made that the disposal of the land necessitated a capital versus revenue argument. Marks that could easily be obtained are lost.
- Read the scenario carefully or you can be drawn down the wrong path. Some candidates thought that the issue was one of thin capitalisation. Two indications are contained in the question to ensure that thin capitalisation was not an issue. Firstly the holding obtained by the UK company was 24% (a holding of 25% is necessary) and secondly, no reference was made to interest on the loan facility granted by the UK company, only the expenditure related to the business of Exchange Data Ltd. As no interest is mentioned, there can be no thin capitalisation discussion.
- Examine the nature of the business of the entity under discussion. A description of the business of Exchange Data Ltd was provided that should have indicated (or provided assistance to the discussion) that the expenditure related to the revenue producing activities of the business. This would have helped candidates to focus on the relevant issue.
- Where optional transactions are provided (such as in part (b)), there must be some reason to distinguish these transactions. This should also provide the clue for the obvious statement that needs to be made (see bullet one).

Question Four

Question four considered a company engaged in the sale and leasing of machinery. The question specifically considered a new suspensive sale arrangement in part (a) and the termination of a finance lease in part (b).

The distinction between suspensive sales and finance leases (as regards the income tax implications) remains an area of difficulty for candidates. Candidates often switch the effects or consider the two transactions to have the same consequences. This is easily rectified by summarising the consequences and practicing answering

questions of this type. Critical to the summary is also the distinction between the lessor / seller of the asset and the lessee / buyer of the asset. Question 4 was entirely concerned with the lessor / selling company, however some candidates discussed the implications for the lessee / buyer. This can be corrected by careful reading of the question. As stated earlier, candidates in general need to read the question carefully and consider the nature of the business under discussion.

Candidates should review the suggested solution carefully to gain insight into areas of weakness and to improve their communication for this area.

Question Five

Few candidates attempted question 5, which concerned an employee share scheme where the employer had decided to interpose / utilise a trust in the scheme. This scenario was based on Binding Private Ruling 001.

Aspects to be addressed in part (a) of this question included:

- (a) Restricted equity instruments for share gains made by employees
- (b) Basic concepts of trusts, including: vesting versus discretionary aspects; distinction between capital and revenue
- (c) Connected person considerations, as the employer and the employees are connected to the Trust
- (d) Separation of income and capital effects (i.e. dividend and share ownership effects).
- (e) Repurchase of shares by the employer

Part (b) addressed the termination of the scheme. Carefully attention to the detail of the scheme would have assisted candidates in scoring marks.