

Examiner's report

P6 (ZAF) Advanced Taxation
December 2016



ACCA

General Comments

The examination consisted of five questions. Section A contained Question 1 for 35 marks and Question 2 for 25 marks. Section B comprised three further questions of 20 marks each. The candidates were only required to answer two of the three questions in Section B.

The vast majority of candidates attempted all of Section A and Question 3 of Section B, with more candidates choosing to attempt Question 4 over Question 5. The majority of candidates did not leave out any questions and there was little evidence of time pressure. Where questions were left unanswered by candidates, this appeared to be due to a lack of knowledge or poor exam technique, as opposed to time pressure, in most cases.

Candidates performed particularly well on questions 1(iv), 2(a)(i), 2(a)(ii), 2(b)(i), 3(a) and 3(b). The questions candidates found most challenging were questions 1(i), 1(ii), 1(iii), 2(b)(ii) and 5(b). This is mainly due to candidates not understanding core syllabus areas well enough; a lack of technical knowledge and also due to a failure to read question requirements carefully. Question 1(i)-(iii) and Question 5 covered the corporate rules of amalgamations and asset-for-share transactions respectively. It appears from the performance in these questions that few candidates prioritised the corporate rules in their studies since the majority of the students were not able to successfully identify the requirements for the application of the rollover relief, nor were the majority able to explain the relief provided.

A number of common issues arose in the candidates' answers:

- Failing to read the question requirement clearly and therefore providing irrelevant answers which scored few if any marks.
- Poor time management between questions, some candidates wrote far too much for some questions (a prime example of this is question 1(iv)) and this put them under time pressure to finish remaining questions.
- Not learning lessons from earlier examiners' reports and hence making the same mistakes.
- Repetition of the facts with limited application of the legislation to the facts.

Specific Comments

Question One

This 35-mark question was concerned with various transactions pertaining to a specific group structure. It specifically considered the acquisition of shares in a company which held a desirable building and a subsequent amalgamation transaction. It tested candidates' knowledge of the general anti-avoidance rules, specific anti-avoidance rules relating to the use of assessed losses, and the requirements, effects and limitations of the corporate rule relating to amalgamation transactions. It also briefly tested candidates' knowledge of tax residence for corporate entities.

Part (i) for 14 marks required candidates to address the risk of any anti-avoidance rules being applied with respect to the lease transaction. The performance was mixed on this part of the question. Many candidates identified that the inflated lease rental and premium was potentially set in order to utilise the assessed loss and in so doing, arrive at taxable income of R nil. However, most candidates did not identify that the General Anti-Avoidance Rules (GAAR) could also be applied to the transaction. Marks were not awarded where candidates simply indicated that 'anti-avoidance rules would apply', without specifying which anti-avoidance rules they were referring to. There seemed to be a lack of understanding of the GAAR in general, so perhaps this is an area for candidates to focus on in future.

Part (ii) for 7 marks required candidates to consider whether or not the amalgamation transaction described in the scenario, would qualify for the relief offered by the amalgamation corporate rule. Most candidates performed inadequately on this part of the question. Many candidates focused on the anti-avoidance rules once again, instead of considering the requirements for amalgamation transactions and applying these requirements to the scenario. It appears that the majority of candidates did not include this piece of legislation in their revision. A thorough study of the corporate rules relating to amalgamations would have assisted candidates in answering this question.

Part (iii) for 9 marks in total, required an explanation of: (1) the income tax relief offered under the amalgamation corporate rule for 5 marks; and (2) the identification of any limitations to be considered with respect to the rule's application for 4 marks. Since this part of the question asked candidates to assume that the amalgamation transaction qualified for relief under the relevant corporate rule, it was purely a test of candidates' technical knowledge relating to this section (namely, section 44) of the Income Tax Act. Performance on this part of the question was unsatisfactory, which appears to confirm that this particular area of the tax legislation was not considered when most candidates were preparing for this examination. Instead of considering the specific relief and limitations set out in section 44, most students continued to consider the application of anti-avoidance legislation in this part, which seems once again to point to a lack of knowledge of the amalgamation corporate rule.

Part (iv) for 1 mark required the consideration of impact of Sam Quick's emigration on the corporate residence of Hold (Pty) Ltd. This part of the question was generally well answered, with most candidates identifying that since the company was incorporated in South Africa, Sam Quick's emigration would have no impact on the corporate residence of the holding company. The only concern with this part was that many candidates wrote very lengthy responses which would have put them under time pressure in other parts of the paper. Candidates are reminded to be guided by the mark allocation (which was just 1 mark in this case).

In general, the writing style of the candidates was appropriate for a professional report of this nature and most candidates were able to score an easy mark by setting the report out in the appropriate format for a memorandum.

Question Two

This 25-mark question covered the topics of the sale of a going concern from a VAT perspective, capital gains tax consequences of property acquired and disposed of in foreign currencies, capital gains tax consequences of the sale of shares in a property rich company by a resident / non-resident, and the tax consequences of a share repurchase transaction.

Part (a)(i) for 5 marks required candidates to advise the taxpayer of the VAT consequences of the sale of his business. Candidates' performance was satisfactory on this part of the question, with the majority of candidates correctly identifying that the transaction could qualify as the sale of going concern and listing many of the requirements that would need to be met in order for the sale to be zero-rated.

Part (a)(ii) for 7 marks required candidates to advise the taxpayer on the income tax consequences for the 2016 year of assessment of the disposal of his property in Flottenburg. Candidates' performance was satisfactory on this question, with the majority of candidates correctly identifying that the taxpayer's base cost in respect of his property would be stepped up on immigration, and that strict translation rules would need to be applied when calculating the proceeds and the base cost of the asset disposal. A pleasing number of candidates recognised that a foreign tax rebate may be claimed in respect of the tax paid in Flottenburg.

Part (b)(i) for 7 marks required candidates to calculate the capital gains implications on the disposal of the taxpayer's shares in Coccia (Pty) Ltd and use such calculation to support their views as to whether the taxpayer should sell his shares before or after his emigration. Candidates' performance was mixed on this part of the

question. Many candidates missed the following crucial point: on emigration, there would be a deemed disposal of the shares and the market value on such date would become the new base cost of the asset. This new base cost should be used in the calculation of the capital gain on the disposal of the shares post-emigration. Since the shares are 'property-rich', they remain in the 'CGT net' post-emigration. A few students managed to identify that although the tax cost was higher post-emigration, this was more than offset by the increase in the profit on the sale, from a cash perspective.

Part (b)(ii) for 6 marks required candidates to consider the tax implications of a share repurchase transaction. Candidates' performance was unsatisfactory on this part of the question. The tax consequences of a share repurchase are quite specific – candidates needed to recognise that the consideration given in respect of the share repurchase would meet the definition of a dividend for income tax purposes (since the question indicated that no reduction of contributed tax capital would be elected). As such, the dividend would be included in Jeremy's gross income, but would qualify for exemption. Dividends tax would however be payable as Jeremy would not qualify for any dividends tax exemptions. Furthermore, since Jeremy has disposed of an asset, the capital gains tax consequences would need to be considered. Specifically, candidates needed to identify that since proceeds must be reduced by any amounts included in gross income (i.e. the dividend), the proceeds would effectively be R nil, resulting in a capital loss (which may be a 'clogged loss'). No candidates managed to identify all of the afore-mentioned tax consequences, which indicate a gap in technical knowledge. Candidates are encouraged to include the tax implications of share repurchase transactions in their revision work.

Question Three

This 20 mark question considered Denise, a South African tax resident under the age of 65, who is a sole proprietor of an online clothing boutique making sales to customers in both South Africa and neighbouring countries. The online orders are packed and couriered by Denise direct to the customer. Denise is also registered as a VAT vendor. Denise is now considering employing two further employees in her business – a personal assistant for herself to assist in the business, and a child minder to look after her two children and to drive them to and from school. The personal assistant's employment package will be a salary of R16,000 per month plus a 50% employer contribution to a medical aid scheme. The child minder's employment package will be a salary of R8,000 per month with an additional R1,000 monthly travel allowance. Denise's business has an anticipated taxable income of R14 million in the 2016 year of assessment. The question tested the VAT implications of the sales made by the business, the income tax and employees' tax implications of the new hires and the potential availability of any preferential tax regimes that Denise could consider for her business going forward.

Part (a) for 3 marks simply required candidates to explain the VAT implications (standard or zero rated supply) for Denise's sales to customers in South Africa and neighbouring countries. Candidates performed adequately on this question. If they did not score full marks it was because they failed to explain why the sales to neighbouring countries were zero rated.

Part (b) for 9 marks required candidates to explain the income tax deductibility of the salaries payable to the two new employees, and the withholding requirement and calculations in respect of employees tax to be withheld from the two new employees. Candidates' performance was mixed on this question, with the majority of candidates correctly identifying that the personal assistant's salary was deductible, that the child minder's salary was not deductible for the business, and that Denise was required to register as an employer and withhold employee's tax from both employees. Where some candidates did not score full marks however was in respect of the calculation of the PAYE to be withheld, and in particular the application of the rules regarding the taxation of the medical aid contribution and the credit that may be claimed, the taxation of the travel allowance and the application of the primary tax rebate.

Part (c) for 8 marks required candidates to advise Denise on any beneficial tax regimes available to her and to indicate to her the steps which should be taken to access these. Candidates' performance was mixed on this question. The majority of candidates identified that the small business corporation regime would provide tax

benefits. Candidates were less successful however at identifying that the business of a sole proprietor would first need to be 'incorporated' in a company in order to access this relief. In addition, whilst some candidates could cite the requirements for the application of the regime, application to the facts and in particular advising Denise (as required by the question) was poor.

Question Four

This 20-mark question involved Complete Consulting Solutions (Pty) Ltd, a South African engineering company and registered VAT vendor, which secured two different contracts with the Botswana government to provide various technical services in relation to various 'Water Projects' to be undertaken by Botswana in conjunction with Lesotho and Zambia respectively. In the process of negotiating these contracts, CCS incurred various expenses in relation to accommodation and entertainment for government officials invited to South Africa from Botswana, Lesotho and Zambia. Furthermore, Jason (a shareholder in CCS who was employed as an engineer by the company) was required to work in Botswana for various periods of time and received a subsistence allowance. He then also borrowed an interest free loan from the company in order to purchase a property in Botswana.

Part (a) for 5 marks required candidates to explain the various VAT implications for CCS arising from the scenario provided. Candidates performed adequately on this question. Most candidates correctly identified the zero rated VAT implications for the two contracts concluded by CSS, as well as the input VAT denied on the entertainment expenditure. Fewer candidates however noted the VAT implications for CCS on the subsistence allowance granted to Jason correctly and no candidates identified that the interest free loan was not a supply and had no VAT implications. This was potentially due to not reading the question carefully.

Part (b) for 5 marks required candidates to explain the tax implications of the Jason in the scenario provided. Candidates' performance was mixed on this question. Most identified the fringe benefit on the interest-free loan correctly (though not all calculated the amount to be included in gross income, which was asked of them – again potentially due to their not reading the question carefully enough), and the correct tax treatment for the subsistence allowance. Very few candidates however correctly identified that the amounts earned by Jason (including the allowance) were exempt from income tax in SA because he met the requirements for employment services rendered outside of the country.

Part (c) for 10 marks required candidates to explain the tax implications for CCS of the various transactions included in the scenario provided. This question was not well answered. Whilst some candidates did at least identify the principle of taxation on worldwide income and the principles of receipt and accrual, the calculations were not well performed and in particular the treatment of the exchange differences which arose was particularly poor. In addition, the candidates did not demonstrate any level of understanding of the rebates and/or deductions allowed for foreign taxes suffered nor any particular mastery of the concept of withholding taxes and DTA relief.

Question Five

This 20-mark question was based on a proposed estate planning restructure in terms of which Richard would first divest himself of half of the assets in his estate by donating them to his wife, with whom he was married out-of-community of property, where after they would jointly enter into an 'asset-for-share' transaction with a resident company (Alpha Co) newly formed for this purpose.

In part (a) candidates were required, for 4 marks, to explain the tax implications for Richard and/or his spouse of the proposed donation of half of the assets in his estate. Most candidates successfully identified that this would be a disposal for capital gains tax purposes and that donations tax could also be levied on Richard. Not all candidates however identified that CGT roll over relief is applicable between spouses and/or that a donations tax exemption exists for transfers between spouses. Of those who did identify that relief is available, none however correctly explained how the CGT relief works and applied it to the facts (i.e. rollover of base cost to the spouse).

In addition, no candidates identified the potential transfer duty which would arise on the transfer of the share in the various immovable properties cited in the question.

In part (b) candidates were required, for 16 marks, to explain in detail the tax implications for Richard and his spouse of the proposed 'asset-for-share' transaction with Alpha Co. Whilst not expressly stated, the level of detail required by the mark allocation meant that candidates should have:

- identified section 42 as being applicable in the circumstances;
- assessed the requirements of the section in order for the relief to apply, and applied these requirements to the facts provided before drawing an appropriate conclusion;
- explained how the CGT roll over relief would work for the individuals and for the company, whilst identifying the potential clawbacks that should be noted; and
- highlighted the tax implications for those assets not covered by the roll over (the base cost for the motor vehicles was higher than their market value).

Few candidates appeared to even be aware of the provisions of section 42 of the Income Tax Act and therefore the performance on this question was particularly unsatisfactory. Candidates should have identified that the relief would apply to a transaction between these individuals and the company even though they were not a 'group'. All candidates instead incorrectly proceeded to calculate the various capital gains that would arise for Richard and his spouse. Candidates are encouraged to include section 42 in their revision, and this appears to be a topic which requires further emphasis in future.