Examiner's report
P6 (ZAF) Advanced Tax
June 2016

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 5 of Section B, with more candidates choosing to attempt Question 3 over Question 4. 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(a), 1(c), 1(d), 2(a)(i), 2(a)(ii), 2(b), 3(b) and Question 5. The questions candidates found most challenging were questions 1(e), 2(c)(i), 2(c)(ii), 3(c), 3(d), 3(e), 3(f). 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 2c(i) covered, among other topics, the income tax consequences of debt reduction (with reference to paragraph 12A of the Eighth Schedule to the Income Tax Act, and section 19 of the Income Tax Act). The debt reduction rules are relatively new, but it appears that few candidates prioritised this section since the majority of candidates did not consider what the debt funded, which is the first step in applying the aforementioned legislation.

A number of common issues arose in candidate's 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 and this put them under time pressure to finish remaining questions.
- Not learning lessons from earlier examiner's reports and hence making the same mistakes.
- Repetition of the facts with limited application of the legislation to the facts.
- Illegible handwriting and poor layout of answers.

Specific Comments

Question One
This 35-mark question was concerned with the sale of exclusive rights to licence intellectual property (IP) software to an offshore company with three options as to how the structure could be effected. It tested candidates' knowledge of basic capital / revenue principles, part disposals for capital gains tax purposes, transfer pricing, controlled foreign companies, and the treatment of foreign dividends, as well as the mechanics of the use of foreign trusts.

Part (a) for 8 marks required candidates to consider whether the sale of the software IP is capital or revenue in nature and if the sale is a capital transaction and concluded at market value, what the base cost would be for the purposes of capital gains tax.

Most candidates performed adequately on this part of the question, particularly with reference to the capital / revenue nature arguments provided. The main problems encountered were that

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candidates did not identify that since only the rights to licence the software were sold, this represents a part disposal of an asset and therefore the calculation of the base cost should be made using the formula for part disposals. Also, the majority of candidates considered that the notional time spent developing the software should be added to the base cost, but of course such time is not expenditure actually incurred and should thus not be included (see paragraph 20 of the Eighth Schedule).

Part (b) for 8 marks required candidates to consider whether the South African Revenue Service (SARS) might consider challenging the sales price of the exclusive right to IP Co Ltd and what the tax consequences would be for Miss P should SARS believe that the price is 40% below market value.

Most candidates performed inadequately on this part of the question. While many candidates successfully identified that Miss P and IP Co were connected persons and that Miss P was deriving a tax benefit as a result of the lower than market-related proceeds (resulting in a lower capital gain), only a minority of candidates successfully identified that the transfer pricing adjustment would result in donations tax (since Miss P is a natural person) and still fewer candidates successfully calculated the value of the transfer pricing adjustment and 'penalty'. Further revision of the transfer pricing legislation would have assisted candidates in answering this question.

Part (c) for 8 marks required an identification of whether IP Co Ltd will be a controlled foreign company (CFC) under each of the suggested options (A, B and C) and if so, what the South African tax consequences would be for Miss P.

Performance on this part of the question was generally satisfactory with reference to the application of the CFC legislation to Option A. The application with reference to Option B and C was less successful, since candidates seemed unsure of how the vested and discretionary interest in the foreign trust (which in turn held the shares in IP Co Ltd) would affect the analysis. For Option B, what many candidates missed was that Miss P held participation rights in IP Co Ltd by virtue of being a *vested* beneficiary of the trust, which meant she was able to participate in the benefits attaching to the shares held by the trust (i.e. the dividend income). However, with Option C, as a discretionary beneficiary, Miss P only has a mere hope or *spes* of participating in the benefits attaching to the shares, as such participation is dependent on the exercise of the trustees' discretion. Some candidates appeared uncertain as to what the effect of IP Co Ltd being classified as a CFC would be, with many candidates incorrectly stating that IP Co Ltd would be taxed in South Africa on its net profits. In actual fact, the effect would be that 100% of the profits of IP Co Ltd would be *attributed* to Miss P and would be taxed in her hands. The errors encountered point to a lack of understanding of the CFC legislation and further study of these rules is encouraged.

Part (d) for 4 marks required a consideration of the tax implications of the income received by Miss P as a result of any dividend distribution made. This part of the question was generally well answered, with most candidates identifying the foreign dividend exemption due to CFC attribution and some students successfully identifying that the partial dividend exemption (26/41) would apply for Option C.

Part (e) for 4 marks required the consideration of the following hypothetical scenario: If in the case of option C, the foreign trust retained the foreign dividends received from IP Co Ltd (other than those used to make the loan repayment), and made a trust distribution only after the end of the

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foreign tax year (which would also be Miss P's next year of assessment), how would the South African tax treatment differ from the position given in the candidates' answer to 1(d).

Most candidates performed inadequately on this part of the question. The main problem was that candidates did not successfully identify that dividends retained in the trust would form part of the capital (retained income) of the trust in the following year and the vesting of such capital in the beneficiary in the subsequent year would result in such capital being deemed to be income in Miss P's hands (since it would have been income in the hands of the trust if the trust had been a South African tax resident and such income had not yet been taxed in South Africa). Candidates are encouraged to revise the income tax consequences relating to transactions with foreign trusts.

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.

Question Two

This 25-mark question covered the topics of general deductions, employees' tax, the gross income definition (with an emphasis on underlying case law principles surrounding 'receipt'), debt reduction, s103(2) of the Income Tax Act, capital loss limitation rules, and the corporate rules.

Part (a)(i) for 4 marks required candidates to advise Feed Co (Pty) Ltd (FC) as to whether the reimbursement payments made to Feed Global LLC (FCG) were tax deductible. Candidates' performance was satisfactory on this question, with the majority of candidates correctly applying at least *some* of the elements of s11(a) to the information provided to arrive at a conclusion regarding the deductibility of the amount in question. Common errors were that candidates did not consider all of the elements of s11(a) in their answers and just focused on perhaps one or two and thus missed marks for a brief consideration of the other elements. Candidates are also encouraged to carefully consider whether they are correctly applying the underlying principles to the facts presented to provide a clear argument. For example, simply stating that the amount was 'actually' incurred, is not sufficient. The candidates should : (i) state the principle (i.e. an amount is actually incurred when Feed Co Ltd has an *unconditional obligation* to pay that amount) and (ii) then apply the principle to the facts (i.e. in terms of the between the two entities, on the CIAD, the Feed Co (Pty) Ltd becomes obliged to pay the amount) and (iii) then a conclusion should be drawn (i.e. therefore the expense is 'actually incurred' on the CIAD). This process should be repeated for each of the elements of s11(a) to fully answer the question and using this exam technique will be of benefit to the candidates.

Part (a)(ii) for 2 marks required candidates to advise the company whether or not employees' tax should be withheld on the payments made to the sales representatives under the cash incentive awards programme. Candidates' performance was satisfactory on this question, with the majority of candidates correctly identifying that an employer that pays remuneration will have an obligation to withhold employees' tax and there was some evidence of candidates acknowledging that the cash incentive payments were akin to bonus payments and therefore constituted remuneration.

Part (b) for 4 marks required candidates to discuss whether or not the overpayments on the debtors' accounts should be included in FC's gross income. Candidates performed adequately on this question, with the majority of candidates identifying that when applying the underlying principles of the gross income definition, the main issue of contention based on the scenario, was

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whether the amount was 'received'. The primary principle that candidates should have applied was whether the amount was received *for the taxpayer's benefit*. A number of candidates successfully identified this principle, but the application of the principle to the facts provided was often lacking. Candidates should have considered this principle in light of all the facts provided in the question (i.e. how would the principle apply where the credit balances are offset against future purchases; how would it apply where there is no offset; how would it apply where a refund is requested; does the fact that the amounts are kept in a separate account have any persuasive value (Pyott's case)).

Part (c)(i) for 10 marks required candidates to advise on the tax consequences arising for both SA Feed (Pty) Ltd (SAF) and SA Feed Support Services (Pty) Ltd (SAFSS) from a proposed loan write-off, including the consideration of any anti-avoidance provisions which may affect either party. Candidates performed inadequately on this question since there seemed to be a distinct lack of awareness of the debt reduction rules (see paragraph 12A of the Eighth Schedule to the Income Tax Act and section 19 of the Income Tax Act). The majority of candidates did not identify that since the debt was used to fund deductible expenditure, the debt reduction in question would result in a recoupment for SAFSS in terms of section 19 of the Income Tax Act. Candidates are encouraged to prioritise the aforementioned legislation in their studies. Furthermore, the majority of candidates did not identify that the recoupment would then be set off against the large assessed loss in SAFSS unless the specific anti-avoidance provision (see s103(2)) applied. From SAF's perspective, most candidates did not identify that there would potentially be a capital loss on the waiver of the loan and certain loss limitation rules may apply. On the whole, the performance in this part of the question points to a lack of technical knowledge of the topics covered, and candidates are encouraged to revise the debt reduction rules, s103(2), and the loss limitation rules in the Eighth Schedule as it relates to capital losses.

Part (c)(ii) required candidates to advise Feed Co Holdings South Africa (Pty) Ltd (FCH) as to whether or not the proposed restructure (with respect to the transfer of the business of SAFSS to SAF and the liquidation of SAFSS) can be effected using the corporate rules. The majority of candidates did not identify that there are specific corporate rules (s47 liquidation and s46 unbundling rules), that could be applied to achieve exactly the structure that was required by the directors. To assist candidates with corporate restricting questions, they are encouraged to draw diagrams for themselves of the current structure and the proposed structure, to assist them in forming a clear picture of what restructuring is required in order to achieve the proposed structure. No marks would be allocated to such a diagram, but it merely suggested as a helpful exam technique that may make the position clearer to the candidates. This approach, coupled with the technical knowledge of the effect of each of the corporate rules, should enable the candidates to successfully address such a question. A number of candidates considered the intra-group transaction rules (in s45), but the application of this rule alone would not achieve the desired structure. Candidates are encouraged to revise the corporate rules, with specific reference to the requirements to qualify for each of the rules and the structure of the transactions envisaged in these rules.

Question Three

This 20-mark question was based on Henry Otelier and the conversion of a seafront property into a hotel business. The question tested the areas of VAT calculations, administrative requirements of employers, the general anti-avoidance rules, the identification of tax risks such as tax evasion, leasehold improvements from the perspective of the lessor, and the ring-fencing of assessed losses.

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Part (a) for 8 marks required candidates to advise Mr Otelier on the VAT position on the purchase of the seafront property, together with a calculation of the estimated net VAT payable/refundable as at 30 June 2016. Candidates performed adequately on this question, particularly with regard to the calculations. Where candidates did not score full marks this was because they failed to read the question properly (thus leaving out elements such as the fact that the input VAT should be accounted for on 90% of the building contract costs, rather than 100%), or a lack of understanding that a notional input could be claimed by Mr Otelier since the sale was by a non-vendor (subject to Transfer Duty) to a vendor.

Part (b) for 2 marks required candidates to advise Mr Otelier on the administrative requirements to be considered with respect to employing the hotel staff for the purposes of employees' tax. Candidates' performance was satisfactory on this question, with the majority of candidates correctly identifying that Mr Otelier was required to register as an employer, and had a duty to withhold and pay employees' tax, submit the relevant returns and to keep records. Where candidates did not score full marks was generally due to a failure to state that the registration should occur within 21 days.

Part (c) for 2 marks required candidates to advise Mr Otelier as to the tax issues to be considered with respect to the contract with the cleaning company. Candidates performed inadequately on this question with few candidates considering the general anti-avoidance rules. A number of candidates incorrectly applied the transfer pricing provisions (which were not applicable since the transactions were not cross-border transactions) and other candidates incorrectly concluded that the cleaning company was a personal service provider (which was also not applicable since Mr Otelier did not provide the cleaning services himself, among other factors).

Part (d) for 2 marks required candidates to advise Mr Otelier as to the tax implications and risks with respect to the offer made by the second building contractor to do part of the work 'for cash'. Candidates' performance was mixed on this question. The majority of candidates identified that the proposed transaction would amount to tax evasion. Candidates were less successful at identifying that such a transaction would mean that Mr Otelier would not be able to claim the VAT inputs for the portion of services for which no invoice was provided and there would also be the risk that he would not be able to claim a deduction for income tax purposes if he cannot prove that that the expense was incurred.

Part (e) required candidates to advise Mr Otelier on the tax implications with respect to the lease agreement with the chef. Candidates performed inadequately on this question since it seemed as though most candidates had not considered the tax consequences of leasehold improvements from the perspective of the lessor in their revision, and thus the majority of candidates did not identify that the value of the leasehold improvement should be included in Mr Otelier's gross income, but that relief was available. Some candidates applied the legislation as it pertains to lease premiums, as opposed to leasehold improvements. Further revision of this particular topic is encouraged. The majority of candidates were however able to identify the inclusion of the annual lease income in gross income and the VAT output that would be charged on lease income.

Part (f) required candidates to advise Mr Otelier of the limitations which might be applied to the tax losses of the hotel business while Mr Otelier carries on the hotel trade in his own name. Candidates provided varied responses to this question, with many focusing on the general anti-

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avoidance rules or s103(2), but not identifying that there is a specific section relating to the ring-fencing of assessed losses which was more directly applicable based on the facts provided. Candidates should have highlighted the '3 out of 5 years rule', the possibility of using the facts and circumstances test to escape the potential ring-fencing, and a consideration of the '6 out of 10 years rule'.

Question Four

This 20-mark question was a series of unrelated queries from clients, and candidates were required to advise each of the clients on their queries. The question tested the areas of rollover relief for involuntary disposals, restricted equity instruments, the administration rules surrounding late objections, and the concept of a jeopardy assessments. Overall, candidates' performance was unsatisfactory on this question.

Query (a) was concerned with the involuntary disposal of specialised machinery and company vehicles that were destroyed in a fire and the company's concern as to what the income tax and VAT implications may be. Although the candidates seemed to be aware that there was a specific paragraph that could apply in the event of an involuntary disposal as described in the scenario, there was a general lack of technical knowledge relating to the relief offered by the relevant provision (i.e. that for depreciable assets, the capital gain and recoupments could be spread over the useful life of the replacement asset and for non-depreciable assets, the capital gain is deferred until disposal) and a lack of knowledge regarding the requirements to qualify for the relief (i.e. all proceeds must be used to acquire the replacement assets, the contract for replacements assets should be concluded within 12 months and the replacements assets should be brought into use within 3 years). Candidates appeared more comfortable with providing comments on the VAT consequences however, and that aspect of the question was generally addressed with greater success.

Query (b) was concerned with a share option scheme. Few candidates appeared to be aware of the provisions of section 8C of the Income Tax Act and therefore the performance on this question was particularly unsatisfactory. Candidates should have identified that the options and the shares were restricted equity instruments and there would be a loss created at the date of vesting of 1 January 2016. On the sale of the shares - a separate transaction - candidates should have identified that a capital gain would arise. Candidates are encouraged to include section 8C in their revision.

Query (c) required candidates to advise their client as to whether he was still able to object to an assessment. A pleasing number of candidates were able to identify that the client had 30 business days to object to the assessment and that such time period had lapsed. However few candidates identified that the possibility of requesting for a 21 day extension exists if there are reasonable grounds, and any extensions in excess of the 21 days would only be awarded where exceptional circumstances exist.

Query (d) was concerned with the issue of a jeopardy assessment. The majority of candidates appeared unaware of the circumstances in which a jeopardy assessment would be issued (i.e. if it is considered that the payment of tax would be in jeopardy) and therefore the discussions addressing this query were often not on point. Some candidates however, successfully identified that the client could object to the assessment and that the taxpayer's obligation to pay the tax was not suspended by objection or appeal.

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Question Five
This 20-mark question was based on a series of unrelated queries from clients, and candidates were required to prepare a brief summary of the tax issues relevant to each client.

Query (a) was concerned with whether specific items that would appear on the invoice of a tour company issued to its overseas client, would be taxable supplies for VAT purposes and at what rate the VAT should be levied. Performance was mixed with regard to this query and some common errors were as follows:

- Candidates incorrectly concluded that the flights from Munich to Cape Town were exempt from VAT, rather than being zero-rated.
- Candidates in some cases considered that the rental of the vehicles would be an exempt supply, where in fact it is a standard rated supply.
- Candidates applied rules relating to the claiming of input VAT (e.g. input VAT is denied on 'entertainment') to output VAT.
- Candidates did not identify that since the service fees for arranging the tour were supplied to non-resident persons while such persons were outside of South Africa, these services were export services and were therefore zero-rated.

Query (b) was concerned with a mobile phone allowance granted to a sales representative of a company. The majority of candidates successfully identified that R550 allowance would be included in the employee's taxable income (although few identified why i.e. she was not required to keep proof of actual business related expenditure), but few candidates distinguished between the reimbursements of the excess (which would meet the relevant conditions of the expense being incurred at the instruction of the employer and the proof being kept) and the R550 allowance itself. Most candidates applied the legislation as it relates to fringe benefits, rather than considering the specific provisions regarding allowances. Candidates are encouraged to revise this particular topic.

Query (c) required a calculation of the tax payable on a severance benefit and a retirement fund lump sum benefit, as well as the tax payable on 'other' taxable income, in order to arrive at the correct tax liability for the relevant year of assessment. This appears to be a topic which requires further revision as many candidates did not apply the relevant tables correctly. Common errors included using the individual tax tables instead of the specific table for retirement lump sum benefits and severance benefits, while other candidates applied the correct table, but did not apply the procedure for using the table correctly.

Query (d) was primarily concerned with the South African tax consequences of a non-resident holding immovable property in South Africa at the time of death. Candidates should have identified estate duty and capital gains tax as the main tax costs that would arise at death. While the majority of candidates referred to estate duty and capital gains tax in their solutions, there were many errors with regard to what the consequences in relation to these two taxes were. These ranged from candidates stating that since the individual was a non-resident, she would not be subject to estate duty at all, to candidates indicating that there was a R300,000 exclusion for estate duty at death, whereas in actual fact there is a R3.5 million abatement for estate duty and the R300,000 exclusion relates to capital gains tax. The majority of candidates did not appear to be aware that residence for estate duty is limited to whether the taxpayer is ordinarily resident in South Africa, and the physical presence test does not extend to estate duty as a determinant of residence.