Examiner's report
P6 (ZAF) Advanced Taxation
June 2017

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 and Question 4 of Section B, with fewer candidates choosing to attempt 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(b), 1(c), 2(b), 4(a), 4(b) and 4(c). The questions candidates found most challenging were questions 1(a), 1(d), 5(a), 5(b) and 5(c). This is mainly due to candidates not understanding core syllabus areas well enough and also due to a failure to read question requirements carefully. Question 1(a) covered translation of foreign currency proceeds and base cost as well as the consideration the foreign tax credit and the associated limitation. Question 1(d) covered the asset-for-share corporate rule. It appears from the performance in these questions that few candidates prioritised these areas in their studies. Question 5(a) required consideration of the place of effective management of the company, and Question 5(b) required the consideration of whether the company was a personal service provider. It also appears from the performance in these two questions that these areas were not prioritised for study purposes.

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
- 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

Section A

Question One

This 35-mark question was concerned with various transactions pertaining to natural person who recently resigned from her employment and commenced business as a sole proprietor after winning cash in a foreign lottery. It tested candidates' knowledge of the capital revenue arguments in respects of receipts, the rules governing the translation of foreign currency proceeds and base costs, the income tax and VAT implications of running her business as a sole proprietor and the application of the asset-for-share corporate rule to provide relief on incorporation. It also required the candidates to display their professional communication skills by drafting their response in the form of an email to their 'manager'.

Part (a) for 10 marks required candidates to address the tax implications of the foreign lottery winnings including a brief explanation of why the lottery winnings are taxable. The performance was poor for this question. Many candidates identified that the winnings were capital in nature, but failed to correctly apply the necessary translation rules to the foreign currency proceeds and base cost. Candidates also failed to consider the foreign tax rebate claimable by the taxpayer in respect of the foreign tax suffered on the winnings (and the related limitation and carry forward of the excess). There seemed to be a lack of understanding of these topics, so perhaps this is an area for candidates to focus on in future. Many candidates focused on the residence of the taxpayer in answering this question, but as her residence was not in issue (she remained ordinarily resident as she did not emigrate and was only out of the country for seven months) and the time spent focusing on this residence meant that there was less time for candidates to address the relevant topics identified above. Candidates are encouraged to read the questions carefully before considering their response.

Part (b) for 1 mark required candidates to consider the income tax implications for the taxpayer of the repayment of one month's salary and allowance to her former employer. Performance on this question was pleasing with the majority of candidates identifying that the repayments would be deductible for income tax purposes.

Part (c) for 10 marks required candidates to address the tax implications for the taxpayer of running her business as a sole proprietorship, including her withholding responsibilities. Performance on this part of the question was mixed. As the question required consideration of the 'tax implications' many candidates included the income tax implications which was pleasing. In most cases, candidates missed out on marks as they did not consider the VAT implications as well. It appears that this could have been avoided if candidates considered the question more carefully (i.e. 'tax implications' requires consideration of all taxes relevant to the scenario).

Part (d) for 10 marks required candidates identify the tax reliefs on which the taxpayer could rely when incorporating her business, both at the at the date of the transfer and thereafter, including any conditions required for them to be granted to her. 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 since the use of an asset-for-share transaction would be the most tax efficient way to achieve the taxpayer's aim of incorporation. The majority of candidates correctly identified that if the taxpayer incorporated her business, it could potentially qualify as a small business corporation and enjoy the preferential tax rates provided under this regime. Therefore, the majority of candidates were awarded the mark available in this regard. However, the majority of the candidates missed the marks associated with the application of the asset-for-share corporate rule.

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

Question Two

This 25-mark question covered the topics of foreign exchange gains and losses, VAT on imports and exports, the general anti-avoidance rules, transfer pricing adjustments and understatement penalties.

Part (a) for 10 marks required candidates to advise their 'client' of the tax implications of a loan from the South African resident company to a foreign subsidiary, the interest thereon and any tax risks associated with the loan. The performance was mixed with regard to this part of the question. Few candidates identified that both the loan and the interest were exchange items and that the foreign exchange gains and losses would need to be determined at year end and on settlement of the loan. This appears to point to a lack of technical knowledge regarding foreign exchange differences and it is suggested that candidates ensure that they incorporate this topic in their studies in future. On the other hand, most candidates were able to identify that the interest would need to be included in the South African company's gross income and that the transaction would be at the spot rate. Furthermore, the transfer pricing risk potentially resulting in an adjustment to normal tax was identified by a number of students, but few candidates indicated that this may also result in a deemed dividend *in specie* which meant that candidates missed out on some of the marks available in this regard.

Part (b) 9 marks required candidates to advise the taxpayer on as to the tax implications of the import and export of the fruit, including the implications of the wasted fruit as well as a numerical example based on a specified shipment. Candidates' performance was satisfactory on this question, with the majority of candidates correctly identifying that the VAT would be paid on the added tax value for the imports and that the exports would be zero-rated. The majority of candidates also correctly identified that the sales would be included in gross income and that a deduction may be claimed for income tax purposes in respect of the spoiled fruit. Fewer candidates managed to apply the formula for the import duties correctly in their numerical example due, for the most part, to errors in recalling the formula correctly ([customs value, plus any duty levied on the goods, plus 10% of the customs value] x 14%). Candidates are encouraged to learn this formula in future as the calculation itself was straightforward.

Part (c) for 6 marks required the candidates to advise the company as to the tax consequences of the transfer pricing adjustment made by the Commissioner for the South African Revenue Service and to indicate what reasons and mechanisms exist to appeal the decision of the Commissioner. Candidates' performance was mixed on this part of the question. Many candidates identified the quantum of the adjustment made, but few indicated that the penalty consisted of dividends tax at 15% on the deemed dividend *in specie*. With regard to the understatement penalty, the majority of candidates who identified this penalty, applied the 50% penalty to the adjustment, rather than applying it to the tax (the shortfall or prejudice to the *fiscus*) in respect of the adjustment. In other words, candidates were required to first apply the tax rate of 28% to the adjustment and then apply the 50% penalty. Most candidates were able to provide a basis on which the taxpayer could defend their position (valid commercial reasons, arm's length arguments etc.) and therefore candidates performed well in this regard.

Question Three

This 20 mark question considered Prince, a widowed South African tax resident under the age of 65, who created a trust for the benefit of his children and grandchildren and transferred a holiday house to the trust on loan account. Prince also emigrated during the year of assessment. Finally, Prince is concerned about the tax consequences should he die on a date within the year of assessment in question. The question tested candidates' ability to calculate the base cost for a pre-valulation date asset for capital gains tax purposes, as well as the ability to identify the assets remaining in the capital gains tax 'net' post emigration, in order to consider the capital gains tax consequences of these assets on death. The question also tested the ability to identify the assets that would fall within the estate duty 'net' post emigration and to calculate the estate duty liability upon death.

Part (a) for 8 marks required candidates to explain and calculate the tax implications of the transfers to the trust. Candidates' performance on this part was mixed. Many candidates wrote at length about the anti-avoidance rules in section 7 of the Income Tax Act No 58 of 1962 and their application to the question, but because the sale was at market value and since the children were not minor children, the application of section 7 would be limited to the interest free element of the loan and the reach would not be as wide as many candidates indicated. The focus of the question was on the tax implications on the *transfer* of the holiday house, which is a disposal for capital gains tax purposes. The majority of candidates who prepared a capital gains tax calculation, applied the time apportioned base cost formula adequately. However most candidates assumed that the transfer duty could be added to the base cost of the property from Prince's perspective, whereas it is in fact the purchaser (the trust) who bears the transfer duty cost and may therefore add it to its base cost going forward. Candidates are encouraged to read the question carefully before drafting a response. Candidates are further encouraged to revise which party bears the liability for transfer duty.

Part (b) for 12 marks required candidates to explain with the aid of supporting calculations, what the tax implications would be for Prince and his estate on his death, if he were to die during the year of assessment in question. Candidates' performance on this part was mixed. As a starting point, candidates needed to consider that upon death there could be both capital gains tax and estate duty. Many candidates only considered one of the aforementioned taxes and not both. Since Prince had emigrated prior to his suggested date of death, candidates were required to identify that only immovable property in South Africa would still fall within the capital gains tax 'net'. On the other hand, with regard to estate duty, candidates were required to identify that since Prince would be a non-resident at his date of death, only the South African source assets would be included in his estate duty calculation. These are fundamental principles and a lack of technical knowledge in this regard lead many candidates to miss out on marks in this part. Candidates are encouraged to include more capital gains tax and estate duty examples as part of their revision.

Question Four

This 20-mark question involved providing advice to Lesidi, a South African resident who owns a clothing company and has decided to employ a personal assistant. She also sold artworks inherited from her father during the year of assessment. Lesidi's husband, Mpho, requires advice regarding the acquisition and sale of a property in different foreign currencies and the application of relief for foreign taxes incurred in the form of the foreign tax credit.

Part (a) for 6 marks required candidates to calculate the annual cost to Lesidi's company, after income tax, of employing the full-time personal assistant on an annual basis. Candidates performed adequately on this question. The majority of candidates were able to identify many of the costs associated with the personal assistant which would be deductible from an income tax perspective and this effective tax saving would lower the total cost of employing the individual. However, some candidates used valuable time in calculating the pay-as-you-earn tax cost, which is a cost borne by the employee (although withheld by the employer on the employee's behalf) and is not a cost to the employer. This points to an issue with regard to the understanding of who pay-as-you-earn as a withholding tax on the employee.

Part (b) for 6 marks required candidates to discuss whether or not the profit from Lesidi's proposed sale of the art collection would be subject to tax. Candidates' performance was satisfactory on this question. The capital versus revenue arguments were generally well presented, although the majority of candidates only identified one or two of the relevant principles from case law and applied these. Candidates are encouraged to revise these principles to avoid missing out on available marks. Also, only a few candidates identified that, since the assets qualify as personal use assets, the capital gain is excluded. Candidates are encouraged to focus on capital gains tax in general in their studies and for revision purposes.

Part (c) for 8 marks required candidates to advise Mpho of his income tax liability for the year of assessment. This entailed a capital gains tax calculation in respect of the disposal of his foreign property, the application of the tax tables based on total taxable income, and the calculation of the foreign tax paid and the limit on the potential claim of a foreign tax rebate. Candidates performed well on this question, apart from the consideration of the foreign tax rebate where there was a lack of technical knowledge. Candidates are encouraged to revise this topic.

Question Five

This 20-mark question was concerned with Joseph, a South Africa resident who spent time working offshore for an oil company. During the year of assessment, Joseph resigned and formed a company providing the same services to the oil company as he previously provided as an employee. The question tested the application of tax residence for companies and the personal service provider provisions. The question also required candidates to think critically about the tax efficiency of Joseph's new structure.

In part (a) candidates were required, for 6 marks, to explain whether or Joseph's company was resident in South Africa for tax purposes. Performance in this part of the question was disappointing. A large portion of candidates applied the physical presence test to Joseph and then attempted to infer residence to the company on this basis. However, the legislation has separate rules for residence for individuals and corporate entities. For companies, the place of incorporation must be considered, which in the absence of a tie breaker clause in a treaty regarding place of effective management, would be conclusive. The question indicated that one of the countries, Northania, had a treaty with South Africa based on the OECD Model Convention on Income and Capital of 2010. On this basis, the tie breaker clause would need to be considered. Therefore, candidates were required to consider where the key management or commercial decisions of the company were made. Unfortunately, the majority of candidates did not consider the place of effective management. Candidates are encouraged to revise this topic.

Part (b) for 8 marks required candidates to explain whether or not the company is a personal service company and the tax implications if it is so classified. Performance in this part was unsatisfactory. While the majority of candidates concluded that the company was indeed a personal service provider, many candidates did not recall the various requirements or tests to determine this which impaired their ability to justify their position with the required explanation. The majority of candidates identified that the oil companies would be required to withhold pay-as-you-earn on payments to the company, but few candidates identified the impact on the company with regard to the limitations on their deductions. It is recommended that candidates revise this topic for future exams.

Part (c) for 6 marks required candidates to advise Joseph whether, from a South African tax perspective, his current structure is tax efficient, addressing both the advantages and disadvantages of his structure. Performance in this part was poor. There were a number of possible advantages and disadvantages, but the majority of candidates only identified one or two. One of the disadvantages that most candidates failed to recognise was the potential of a deemed dividend (resulting in dividend tax) on the notional market-related interest on the loan from the company to him as shareholder. The majority of candidates also failed to identify that as an employee Joseph may have found that a portion of his earnings was exempt (if he spent more than 183 days, including 60 consecutive days, outside South Africa) and that this exemption would not be available to the company. The majority of candidates also failed to identify that the company would need to register for VAT. Perhaps if candidates had allowed themselves more time to consider the structure, they would have been able to identify more advantages and disadvantages.