Professional Level – Options Module

Advanced Taxation (South Africa)

Monday 3 December 2007

Paper P6 (ZAF)

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 2–3

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

SUPPLEMENTARY INSTRUCTIONS

1. You should assume that the tax rates and allowances for the year of assessment ended 28 February 2007 will continue to apply for the foreseeable future.
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 2007

Rebates	
Primary rebate	R7,200
Secondary rebate (over 65)	R4,500
Interest exemption	
Under 65	R16,500
Over 65	R24,500
Companies	
Normal tax rate	29%
STC rate	12·5%
Trusts	40%
Donations tax	20%
Estate duty	20%

Schedule 1
Rates of normal tax payable by persons (other than companies)
in respect of the year of assessment ended 28 February 2007

Taxable income	Rates of tax
Where the taxable income –	
does not exceed R100,000	18% of each R1 of the taxable income
exceeds R100,000 but does not exceed R160,000	R18,000 plus 25% of the amount over R100,000
exceeds R160,000 but does not exceed R220,000	R33,000 plus 30% of the amount over R160,000
exceeds R220,000 but does not exceed R300,000	R51,000 plus 35% of the amount over R220,000
exceeds R300,000 but does not exceed R400,000	R79,000 plus 38% of the amount over R300,000
exceeds R400,000	R117,000 plus 40% of the amount over R400,000

Rating formula

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

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

Tax rates for small business corporations for the
year of assessment ended 31 March 2007

Taxable income	Rates of tax
R0 – R40,000	Nil
R40,001 – R300,000	10% of the amount over R40,000
R300,001 and above	R26,000 plus 29% of the amount over R300,000

Travel allowance table
for the year of assessment ended 28 February 2007

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	15,364	47·3	22·5
40,001 – 60,000	20,910	49·4	26·2
60,001 – 80,000	25,979	49·4	26·2
80,001 – 100,000	31,513	54·8	30·5
100,001 – 120,000	36,978	54·8	30·5
120,001 – 140,000	41,771	54·8	30·5
140,001 – 160,000	47,512	57·2	39·8
160,001 – 180,000	52,629	57·2	39·8
180,001 – 200,000	58,334	65·9	43·8
200,001 – 220,000	64,591	65·9	43·8
220,001 – 240,000	69,072	65·9	43·8
240,001 – 260,000	74,777	65·9	43·8
260,001 – 280,000	79,918	69·3	52·5
280,001 – 300,000	85,440	69·3	52·5
300,001 – 320,000	88,793	69·3	52·5
320,001 – 340,000	95,218	69·3	52·5
340,001 and above	100,011	77·1	68·0

Where reimbursement is based on actual business kilometres travelled, no other compensation is paid to such employee and the kilometres travelled for business do not exceed 8,000, the prescribed rate is R2·46 per kilometre.

Section A – BOTH questions are compulsory and MUST be attempted

1 Mr Len Philander is 64 years of age, he is married and has two children, a son and a daughter, both of whom are over 25 years of age. His son is a South African resident, but his daughter is a non-resident.

Details of Len's assets at 31 July 2006 are as follows:

	Note	Market value at 31 July 2006	Initial expenditure
		R	R
Family house	1	3,200,000	233,000
Holiday house	2	1,500,000	700,000
Motor car	3	300,000	340,000
11 metre yacht	4	900,000	1,000,000
Investment	5	600,000	200,000
Share portfolio	6	4,100,000	–
Cash		600,000	–

Notes:

1. The family house is being used as his and his wife's primary residence. The house was purchased on 1 July 1980 for R233,000. Since acquisition certain improvements have been made; these amounted to R70,000 in 1990 and R220,000 in October 2005. The market value of the house at 1 October 2001 was R2,200,000.
2. The holiday house, which is situated on the west coast of South Africa, was purchased on 1 December 2001 for R500,000. Additional improvements of R200,000 were made in 2005.
3. The motor car owned by Len is used for business travel and it is estimated that the private use thereof is only about 20% of the travelling allowance Len receives. He keeps actual records to substantiate the 20%. The car was purchased after 1 October 2001.
4. Len purchased the yacht in May 2005. He moors it at a club near his holiday house and pays mooring fees of R25,000 per annum.
5. The investment is a half-share in a partnership. The other partner is Len's sister and she is largely responsible for the running of the business for which she gets a salary. The R200,000 initial expenditure is the capital contributed by Len in 2004. The market value is the value of his half-share. The business had a net taxable loss at 28 February 2006 and 28 February 2007 of R4,200 and R2,400 respectively. It may be assumed that the losses accrued evenly throughout the tax years in question.
6. The share portfolio was inherited from Len's father when he died in 2002. The value of the shares in his father's estate was R2,900,000. They are all SA listed shares.

Len's current will leaves the family house to his wife; the investment to his sister and all his remaining assets equally to his two children.

For some time Len has been considering creating an *inter-vivos* trust, to which he would transfer (by donation) the holiday home and the share portfolio. The trust will be discretionary with regards to both capital and income and have two independent trustees, other than Len himself.

The following information in respect of income and expenditure is relevant:

For the period 1 March 2006 to 31 July 2006	R	R
Interest income		18,000
Dividend income		45,000
Rentals received on letting out the holiday house for two months		12,000
Travel allowance		42,000
Salary	270,000	
Provident fund contributions	(21,600)	248,400
Medical fund contributions – all paid by Len in respect of himself and his wife		8,500
Mooring fees paid for yacht (5 months)		10,417

For the period 1 August 2006 to 28 February 2007	R	R
Interest income		25,000
Dividend income		61,000
Rentals received for letting out the holiday house for one month		6,000
Travel allowance		60,000
Salary	380,000	
Provident fund contributions	(30,400)	349,600
Medical aid contributions		11,900
Mooring fees paid for yacht (7 months)		14,583

Required:

(a) Assuming that Len dies on 31 July 2006 and that the executor sells the share portfolio and the motor car for R5,000,000 and R300,000 respectively:

(i) Calculate Len's taxable income and tax payable for the period ended 31 July 2006. (15 marks)

(ii) Explain how the estate duty liability arising on Len's death will be determined, clearly identifying any reliefs or deductions available. (7 marks)

(b) Assuming that Len does not die but instead creates the *inter-vivos* trust on 31 July 2006, draft a letter to Len advising on the tax implications of the creation of the trust, including in whose hands the trust income will be taxed. Support your advice with relevant calculations of the position if the trust were to pay a distribution to Len's two major children on 28 February 2007 of R10,000 each out of all the income in the trust. (12 marks)

Appropriateness of the format and presentation of the letter and the effectiveness with which the information is communicated. (3 marks)

(37 marks)

2 Argon Optical (Pty) Ltd (Argon) is a South African company carrying on business in Twsani, South Africa. The company manufactures lenses for spectacles as well as for telescopes and microscopes.

Argon is considering opening a branch in the Western Cape (in South Africa). To do this it would need to lease or purchase land. Various options are available as follows.

Option 1
Argon can purchase land with a building thereon from a non vendor for R25 million. The building has been standing vacant for many years and the seller has not been able to claim any allowances. Transfer duty of R1,945,000 will be payable on the transfer to Argon.

Option 2
Argon can purchase an existing factory building for R30 million from a connected person of Argon, who has been claiming a 10% allowance on the building, which had cost them R9 million, and which has been used in a manufacturing process. Argon would have to make certain improvements amounting to R2 million to accommodate the machinery they would need to acquire. The connected person is a vendor for the purposes of value added tax (VAT).

Option 3
Argon can lease a piece of land for 25 years from a VAT vendor. In terms of the lease Argon will have to erect a factory building on the land costing at least R30 million. Argon estimates that the building would cost them R35 million (VAT inclusive) to erect and would take nine months from the inception of the lease to complete. The lease rental is R90,000 per month. In terms of the lease Argon would also have to pay an up front premium of R50,000.

Required:

(a) **Prepare a memorandum for the financial director of Argon Optical (Pty) Ltd (Argon) advising on the value added tax (VAT) and income tax implications (for Argon) arising in respect of each of the three options, showing calculations where necessary.** (16 marks)

Appropriateness of the format and presentation of the memorandum and the effectiveness with which the information is communicated. (2 marks)

(b) **Explain the income tax implications for the lessor in the case of option 3.** (4 marks)

(c) **Explain the VAT implications if Argon were to operate through a branch outside South Africa.** (3 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

3 Sam Odis is a resident of the Republic of South Africa. He carries on a process of manufacture in his own name and is a VAT vendor.

On 1 March 2004 he purchased a new machine for R100,000 in cash in an arm's length transaction.

The machine was brought into use in the manufacturing process on the same day.

On 1 September 2006 Sam traded in the above machine for a more efficient machine costing R150,000. The trade-in price was R125,000. Sam paid the balance of R25,000 owing in respect of the new machine in cash and brought it into use immediately in the manufacturing process.

All amounts are stated inclusive of VAT, where applicable.

Required:

(a) **On the basis that Sam will elect for any options available to him to defer his tax liability, calculate both the normal tax and capital gains tax consequences of the above transactions for the 2006 and 2007 years of assessment, clearly identifying the effect of any tax deferral(s). Assume that the tax rates for 2006 were the same as in 2007.** (14 marks)

(b) **Explain the normal tax and capital gains tax effects of the above transactions in the 2008 year of assessment. Assume that the tax rates for 2008 are the same as in 2007.** (3 marks)

(c) **State the tax implications for Sam if he decides no longer to use the replacement machine in the manufacturing process.** (2 marks)

(19 marks)

4 On 30 November 2006 Jane Reilly ceased to be a resident of the Republic of South Africa. She had liquidated some but not all of her assets in the years prior to emigration.

The assets which she retained were as follows:

1. Her primary residence. As from 1 January 2007 she let this house to a tenant for a market related rental. She had purchased the house on 1 June 2003 for R950,000. Its market value on 30 November 2006 was R2·2 million.
2. Dividend-yielding shares. These shares had been purchased on 1 March 2001 for R150,000. The shares are listed on the Johannesburg Stock Exchange. The market value on 30 November 2006 was R162,000.
3. Jane did not sell certain of her personal use assets as she took them with her to her new country. These assets had cost her R50,000 and had a market value on 30 November 2006 of R35,000.
4. Jane owned a 17 metre yacht. As she participated in yacht regattas she did not sell the yacht but organised that someone would sail it to her new country for her. She has no records of its cost but its market value on 1 October 2001 was R850,000. The yacht's market value on 30 November 2006 was R750,000.

Other information:

1. Jane owned a holiday house in South Africa which she sold on 1 November 2006 for R1,875,000. Selling costs amounted to R22,000. The base cost of the house was R800,000 in 1990, but she adopted the market value at 1 October 2001 of R900,000.
2. Jane has a capital loss brought forward from the 2006 year of assessment of R3,400.

Required:

(a) Explain the capital gains tax implications arising in the case of each of the assets retained (items 1 to 4) and the holiday house sold. Support your explanations with relevant calculations. (13 marks)

(b) Summarise the income tax effect of the above, for the 2007 year of assessment. (3 marks)

(c) Explain the capital gains tax implications if Jane remained ordinarily resident but physically left the Republic of South Africa for an indefinite period. (3 marks)

(19 marks)

5 Jamie Oldfield is a production manager for Colt Enterprises (Pty) Ltd (Colt). He is in the process of relocating to Durban (South Africa) to work for a branch of Colt. He has also been offered a position with a rival organisation and now needs advice on which offer to accept.

Colt cannot match Jamie's other offer but are prepared to consider restructuring his remuneration package.

The two offers are:

1. **Colt**
   A package of R350,000 which can be structured in any way that suits Jamie.

2. **Rival offer**
   A cash salary of R400,000 with no fringe benefits.

Jamie envisages incurring the following expenditures in relation to his employment:

– Car lease rental of R3,650 per month
– Fuel and oil of R1,250 per month
– Car maintenance and insurance of R2,700 per month
– Retirement annuity fund contributions of R4,700 per year

The car lease rental is in respect of a motor car with a cash cost of R136,800 (VAT inclusive). Jamie estimates that he will travel about 27,000 kilometres a year, but will not keep detailed records.

In Durban, Jamie has been offered the use of an unfurnished flat owned by Colt. Jamie will have to pay all electricity and water charges. The flat costs Colt R3,000 per month. Jamie estimates that it would cost him R5,000 per month to rent his own accommodation in Durban.

Jamie is 32 years old and is a resident of South Africa.

Required:

(a) Advise Jamie Oldfield on a tax efficient way to structure the proposed package from Colt Enterprises (Pty) Ltd (Option 1). Support your advice with relevant calculations. (10 marks)

(b) Advise Jamie which position he should accept assuming the type and amount of work is the same for both positions. (9 marks)

(19 marks)

End of Question Paper