Answers

1

Tax Advisor
Firm's address

Spiros Mathei
Client's address

1 December 2008

Dear Spiros

Please find below explanations in respect of your specific concerns regarding the Mathei Family Trust and the proposed donation of your holiday house.

(a) Annuity to yourself

Income passing through a trust retains its nature for tax purposes, as, through case law, the trust is treated merely as a conduit pipe through which the income flows. The R20,000 annuity is therefore considered to be made up of dividends, interest and rentals and the relevant exemptions are available. However, a separate provision, s.10(2)(b) specifically prohibits the dividend exemption when dividends are paid in the form of a annuity. Thus, the amount taxable in your hands will be R240,000 of gross income, less the available interest exemption, which as the interest is foreign interest will be limited to R3,000.

(b) Other amounts taxed in your or your daughters' hands

Your daughter Mira is a non-resident receiving income 'in consequence' of a donation, settlement or disposition made by a resident (yourself). Therefore, s.7(8) will apply and the dividend and rental elements of the R100,000 distribution will be deemed to be taxable on yourself. The foreign (US) interest content will not be taxed in South Africa.

In addition to being taxed on the dividend and rental elements of the distribution to Mira, as settlor, you will also be taxed on the proportion of dividend and rental income retained in the trust under s.7(5). In both cases the dividend exemption will be available.

Riana is a resident and so, as a major, will, herself, be taxed on her R100,000 distribution. Again, exemptions will be available in respect of the dividend element and the first R3,000 of the foreign interest.

Details of the computations of the resulting taxable amounts, of R166,008 for yourself and R69,662 for Riana are given in annexure 1.

(c) Income taxed in the hands of the trust

The trust will be taxed only on the retained income that is not taxed in your hands, i.e. on the interest income of R66,043 (R255,000 – (69,712 + 119,245)). However, as the trust is a non-natural person, no exemption is available and tax will be payable at the flat rate of 40%.

(d) Donation of the holiday house

Donations tax will be payable on the market value of the holiday house at the date of the donation, less the R100,000 annual exemption, assuming you have made no other donations in the year. The rate of tax is 20%, so taking into account the annual exemption, the tax payable based on the property's current value of R1·5 million will be R280,000.

A donation is also a disposal for capital gains tax purposes. However, in addition to the normal base cost, a portion of the donations tax paid based on the formula:

M – A/M x D, where M is the market value, A the normal base cost and D the donations tax paid is also deductible.

As the property was acquired after 1 October 2001, the normal base cost will be the acquisition cost of R500,000 and the gain thus becomes R813,333 (see annexure 2 for the detailed calculation). If this is your only gain in the year, the annual exemption of R15,000 will be deductible and 25% of the remainder i.e. R199,583 will be included in your taxable income.

(e) Sale of residential property by the trustees

Disposal of the residential property by the trustees will give rise to a capital gain in the trust itself. As the property was donated to the trust prior to 1 October 2001, the base cost will be equal to the time apportioned base cost of R1·95 million, as this is greater than the market value on 1 October 2001 of R1·7 million. The resulting gain is, therefore, R1·05 million (see annexure 3 for the detailed calculation). The gain will be split equally between Riana and Mira as it vests in them. Mira's gain however, will attribute to Spiros as she is a non-resident and the residential property was donated to the trust by yourself as a resident. Riana and yourself will both be entitled to the R15,000 annual exclusion if not already used and 25% of the remainder will be included in taxable income.

Please do not hesitate to contact me if you require any further information.

Yours sincerely

Tax adviser

ANNEXURES

1. Taxation of trust income

	R
The trust has income as follows:	
Dividends – local	190,000
Interest – foreign	180,000
Rent – local	325,000
	695,000
Distributions made:	
Annuity – Spiros	(240,000)
Mira	(100,000)
Riana	(100,000)
Retained income	255,000

The income taxable in your hands will thus be:

	R
In consequence of the distribution to Mira:	
Dividends (190,000/695,000 x 100,000)	27,338
Rentals (325,000/695,000 x 100,000)	46,763
In consequence of the income retained in the trust	
Dividends (190,000/695,000 x 255,000)	69,712
Rentals (325,000/695,000 x 255,000)	119,245
Less: dividend exemption (27,338 + 69,712)	(97,050)
	166,008

The income taxable in Riana's hands will be:	
Distribution	100,000
Less: dividend exemption	(27,338)
Less: interest exemption	(3,000)
	69,662

2. Donation of the holiday house by Spiros

	R
Donations tax	
Market value	1,500,000
Less: annual exemption	(100,000)
	1,400,000
Tax at 20%	280,000
Capital gain	
Deemed proceeds (market value)	1,500,000
Less: original base cost	(500,000)
addition for donations tax (1,500,000 – 500,000/1,500,000 x 280,000)	(186,667)
	813,333
Less: annual exemption	(15,000)
	798,333
Included in taxable income – 25%	199,583

3. Disposal of residential property by the trust

	R
Capital gain	
Proceeds	3,000,000
Less: time apportioned base cost (1,500,000 + (3,000,000 – 1,500,000) x 3/10)	(1,950,000)
(greater than 1 October 2001 market value of R1·7 million)	
	1,050,000
Included in taxable income – 50%	525,000

2 Orbis (Pty) Limited

Notes for a meeting with the production director on (date)
Subject: tax implications of certain aspects of the expansion programme.

(a) Sale of old factory building

Value added tax (VAT)

- The factory is an asset used in the course of a business enterprise.
- Therefore, output VAT will be payable on the consideration for the supply of the building.
- The time of supply is when payment is received therefore the output VAT is calculated to the extent of any payment.
- If the amount is paid in full then the output VAT is R2,100,000 (14% x R15 million).

Income tax

- A recoupment will arise on the sale, being the difference between the tax value and the cost inclusive of the renovations.
- A capital gain will arise on the sale as it is sold for more than its original cost.
- The gain will be calculated by deducting the base cost from the proceeds.
- The proceeds must be reduced by the recoupment included in income.
- The base cost must be reduced by any allowances claimed on the asset.
- The building was purchased before 1 October 2001 therefore the higher of the market value at that date and the time apportioned base cost formula can be used for the base cost.
- The proceeds value in the time apportionment formula has to be adjusted as expenditure was incurred before and after 1 October 2001.
- The determined capital gain is aggregated with other capital gains and reduced by capital losses.
- 50% of the gain is included in taxable income.

(b) Allowances and deductions in respect of the new factory

- An annual building allowance of 5% of the costs incurred, in excess of the amount of R50 million specified in the lease agreement of R250,000 (R5 million x 5%) – s.13(1).
- The R50 million lease obligation will be written off over the period of the lease remaining from completion date but will be limited to 25 years – s.11(f).
- Borrowing costs which are incurred prior to the building being brought into use are deductible once the building is in use – s.11(bA).
- Borrowing costs incurred after the building is brought into use are deductible on an annual basis – s.11(a) or s.24J.

(c) Treatment of the loan interest

- As there is a premium payable at the end of the loan period, the loan is subject to s.24J and interest will be assessed on a yield to maturity basis.
- The yield to maturity is 11·06% per annum and the accrual period 12 months, therefore, the interest incurred in year one is R3,318,000 (R30,000,000 x 11·06%).
- In year two the interest incurred in year one is added to the initial amount, the interest paid of R3,000,000 deducted and the YTM is applied to this adjusted initial amount.
- The interest incurred is deducted each year, apportioned for any period that is not a full year.

(d) Sale of old machine

- As for the sale of the factory above, the disposal will result in both a recoupment of the allowances received and a capital gain.
- For both purposes the deemed proceeds will be the market value, as it is sold to a connected person.
- In the case of the recoupment, however, proceeds are limited to cost. Thus, the uplift to market value will have no effect on the amount of allowances recouped.
- But the value of the proceeds will increase by R500,000 when calculating the capital gain, thus an additional gain of R250,000 (50% of R1·5m – R1m) will be included in taxable income.

(e) Alternatives available for the purchase of the new machine

(i) Cash purchase
  - VAT input of R980,000 (R7 million x 14%) can be claimed
  - A s.12C allowance of R2,800,000 (40% of R7 million) can be claimed in the first year of use. Thereafter the allowance is 20% per year for the next three years.
  - Interest on the loan may be deducted – s.11(a).

(ii) Suspensive sale
  - A VAT input of R980,000 can be claimed (as above)
  - A s.12C allowance may be claimed (as above).
  - The interest on the suspensive sale of R3,920,040 (R198,334 x 60 – R7,980,000) may also be claimed over the period of the agreement – s.11(bB).

(iii) Lease agreement
- A VAT input of R980,000 can be claimed up front.
- The lease payments are deductible for income tax but must be reduced by a portion of the VAT recovered i.e. the rental deduction per month will be R182,000 (R198,334 – 980,000/60).
- At the end of the lease agreement a recoupment will be included in income of the market value of R600,000 less the consideration paid of R500,000.

3 Len Warren

(a) (i) There is no specific definition of 'ordinarily resident' in the Income Tax Act. Therefore, in determining whether a person is or is not ordinarily resident, certain questions, based on case law, need to be asked.

- The country 'where one would naturally and as a matter of course return to from one's wanderings' [*Cohen*'s case].
- The country 'which might be aptly described as one's real home' [*Kuttel* and *Cohen* cases].

In answering the above questions there has to be an intention for the country to be one's real home and that intention must be carried out.

The taxpayer's *ipse dixit*, place of business interest, family and social relations are all relevant in deciding whether one is ordinarily resident.

(ii) 2007 year of assessment
- Len is ordinarily resident until 1 December 2006, the date of his emigration.
- Where a person is 'ordinarily resident' in South Africa then the physical presence test is irrelevant.
- Therefore the physical presence test cannot apply for the rest of the 2007 year.
- Thus, Len will be resident for the whole of the year of assessement 2007.

2008 year of assessment
- Len is not ordinarily resident therefore, as he is spending time in South Africa the physical presence test will apply.
- From 1 November 2007 to 29 February 2008 is more than 91 days.
- In each of the previous five years Len was in South Africa for more than 91 days.
- In total he was present for 985 (195 + 160 + 180 + 330 + 120) days. This is greater than 915 days.
- He will therefore be a 'resident' and will be deemed to be a resident from the beginning of the year of assessment, i.e. 1 March 2007.

The only way Len could escape from the physical presence test is if he was deemed to be exclusively a resident of New Zealand or of another country in terms of a double tax treaty.

(b) Mary Mostert

- As the pattern was devised and created in South Africa the origin of the income is deemed to be from a South African source [*Millin's* case]
  Her gross income will be

Royalties – the Netherlands	R200,000
Royalties – South Africa	R150,000
Tax value	R350,000

- Section 35 of the Income Tax Act will apply to the royalties from South Africa of R150,000. As she is a non-resident.
- Because s.35 applies the R150,000 will be exempt from tax under s.10(1)(l).
- The R150,000 will instead be subject to withholding tax of 12% of R150,000. This is a final tax.
- The royalties earned in the Netherlands of R200,000 will be subject to normal tax in South Africa. Deductions will be allowed if any.

Taxable income

		R
Royalties		350,000
Exemption 10(1)(l)		(150,000)
Taxable income		200,000
Tax payable	(43,125 – 7,740)	35,385
Withholding tax on SA royalties		R18,000

4 A company

(a) (1) Input VAT may not be claimed as input is denied on all motor cars.

(2) Input VAT of R700 (R5,700 x $^{14}/_{114}$) may be claimed on receipt of a tax invoice.

(3) Input VAT of R14,000 (R114,000 x $^{14}/_{114}$) may be claimed as the pick-up truck is not a motor car as defined. It can be claimed on receipt of a tax invoice.

(b)

			R	R
(1)	VAT output on the use of the motor car – fringe benefit value	225,720 x $^{100}/_{114}$ x 0·3%	594	
		594 x $^{14}/_{114}$		73
(2)	Television set			
	Fringe benefit value	5,700 x $^{100}/_{114}$	5,000	
	Less amount allowed		(5,000)	
	Output VAT is Nil			Nil
	VAT is calculated on the fringe benefit value.			
(3)	Pick-up truck			
	Fringe benefit value	114,000 x $^{100}/_{114}$	100,000	
	Less amount allowed		(5,000)	
			95,000	
	Output VAT	R95,000 x $^{14}/_{114}$		11,667
	VAT is calculated on the fringe benefit value.			
(4)	Trading stock donated			
	Output VAT is payable as it is a supply for no consideration out of the course of the enterprise's business.			
	Output VAT = market value	R2,000 x $^{14}/_{114}$		246
(5)	Trading stock given			
	It can be argued that this was given in the course of the enterprise's business as it was for advertising purposes.			
	The output VAT would be	$^{14}/_{114}$ x consideration		
	consideration = nil	so output VAT is nil		

(c) (1) The employer can deduct wear and tear on the motor car and the running expenses incurred for the vehicle, fuel maintenance etc.
Wear and tear is calculated on the VAT inclusive amount as input was denied.
A deduction is also allowed for the output VAT of R73.

(2) The employer can deduct the expense of R5,000 as a cost of employment.

(3) The employer can deduct the expense of R100,000 as a cost of employment.
The output VAT incurred of R11,667 is deductible.

(4) The employer will have a recoupment in income of the market value of the trading stock given – s.8(4)(k). A deduction is allowed for the output VAT amount of R246.

(5) A recoupment would be included in income of R12,000 and a corresponding deduction of R12,000 would be allowed as it is an expense of the business – advertising.

5 (a) Libro (Pty) Limited

Transaction 1

The machine qualifies for a s.12C allowance as it is brought into use for the first time by Libro.
The machine is acquired from a connected person, Paul Cooper holds at least 20% of the equity shares of Libro.
The allowance is therefore based on:

				R
The cost to Paul Cooper				400,000
Less allowances claimed	80% x 400,000			(320,000)
Tax value				80,000
Add recoupment	(280,000 – 80,000)			200,000
(Market value is substituted for proceeds as they are connected)				280,000
Add capital gain				
Market value is substituted for proceeds			280,000	
		R		
Less recoupment		(200,000)		
Less base cost	(400,000 – 320,000)	(80,000)		
		Nil		Nil
Cost for allowance				280,000
Section 12C allowance is	20% as it is not new			
	R280,000 x 20%			56,000

The allowance is not apportioned

Transaction 2

No deduction is allowed for the leasehold improvement as stipulated in the lease agreement as it does not represent gross income in the hands of the lessor (s.11(g) provisio (vi))
The building is being used wholly in a process of manufacture, therefore the building allowance can be claimed as follows:

Cost of building	R8,550,000 x 100/114	R7,500,000
Allowance	5% x 7,500,000	R375,000

The lease rental is deductible in terms of s.11(a) – If Libro is trading from 1 March 2007 the lease does not have to be apportioned from the date of completion of the building.

	R13,000 x 10	R130,000

(b) Dido (Pty) Limited

Before s.103(2) can be successfully applied against Dido, it is necessary that:

(1) there is a change in shareholding or an agreement; and
(2) that as a direct or indirect result of this transaction, income has accrued to the company with the assessed loss; and
(3) the sale or main purpose of the transaction was to avoid a tax on income collected by the Commissioner

The first two requirements are met.

The Commissioner in s.103(4) is entitled to presume, until proven otherwise by the taxpayer, that the purpose of the new income was to utilise the assessed loss.

The onus is on Dido to prove that the sole or main purpose was not to utilise the assessed loss.

It is possible that Dido could discharge this onus on the basis that it did not have the required finance to build a warehouse which it needed.

This argument could be countered by the fact that loan facilities were available from Libro and this approach was not taken as any interest expense would increase the assessed loss whereas the arrangement utilised the assessed loss.

On balance it is probable that s.103(2) could be successfully applied.

			Marks	*Marks*
1	**(a)**	Conduit principle	2	
		Dividend exemption/s.10(2)(b) prohibition	1	
		Interest exemption/amount with reason	1	
		Application to annuity/taxable amount	1	
				5
	(b)	Mira		
		Dividends and rentals taxed on Spiros, with reason	2	
		Interest not taxed in SA, with reason	1	
		Spiros		
		Dividends and rentals in retained income, with reason	2	
		Dividend exemption	0·5	
		Riana		
		Taxable in own right, with reason	1	
		Dividend exemption	0·5	
		Interest exemption	0·5	
		Calculation/annexure		
		Disposition of trust income	1	
		Computation of taxable income: Spiros	1	
		Riana	0·5	
				10
	(c)	Taxed on interest retained, with reason	1	
		No exemption, with reason	1	
		Rate of tax – 40%	1	
				3
	(d)	Donations tax	2	
		Also, disposal for capital gains tax	1	
		Deduction for donations tax paid	1·5	
		Annual exemption/25% taxable	1	
		Calculations/annexure		
		Donations tax	0·5	
		Capital gains tax	1	
				7
	(e)	Capital gain in the trust	1	
		Base cost greater of TABC and MV 1 October 2001, with reason	0·5	
		50% of gain taxable, with reason	1	
		Computation/annexure	1·5	
				4
		Format and presentation of the letter	1	
		Effectiveness with which the information is communicated	1	
				2
				31

			Marks	Marks
2	**(a)**	Value added tax: principles	2	
		output VAT recoverable	0·5	
		Income tax: recoupment	1	
		Capital gain as sold for more than cost	1	
		Adjustments re recoupment	1	
		Effect of pre 1 October 2001 purchase	1	
		Effect on formula of pre and post 1 October 2001 expenditure	1	
		Aggregation of gains and losses	1	
		50% taxable	0·5	
				9
	(b)	Building allowance on excess	1	
		Write off of lease obligation	1	
		Borrowing costs	2	
				4
	(c)	Basis applied, with reason	1	
		Application to years 1 and 2	1·5	
		Apportionment to periods of less than a year	0·5	
				3
	(d)	Both recoupment and capital gain	0·5	
		Use of market value, with reason	1	
		No effect re recoupment, limited to allowances received	1	
		Increases capital gain	1	
		Quantification of additional taxable income	0·5	
				4
	(e)	Cash purchase: VAT input	1	
		s.12C allowances	1	
		Loan interest	0·5	
		Suspensive sale: VAT input	0·5	
		s.12C allowances	0·5	
		Interest	1	
		Lease agreement: VAT input	0·5	
		Lease payments	1	
		Recoupment	1	
				7
		Format and presentation of notes	1	
		Effectiveness with which the information is communicated	1	
				2
				29

				Marks	Marks
3	(a)	(i)	No statutory definition/case law	1	
			Naturally return principle	1	
			One's real home principle	1	
			Effect of intention	1	
			Place of interest – business, family etc	1	
					5
		(ii)	2007 year: ordinarily resident	1	
			physical presence test not relevant	1	
			conclude correctly from principles	0·5	
			2008 year: not ordinarily resident	1	
			application of physical presence test	3	
			conclude correctly from principles	0·5	
			Possible effect of double tax treaty	1	
					8
	(b)		South African source, with reason	1	
			Gross income	0·5	
			Application of s.35 to SA royalties, with reasons	2	
			Withholding tax payable	1	
			SA tax position re overseas royalties	1·5	
			Tax payable	1	
					7
					20
4	(a)	(1)	Input VAT denied, with reason	1	
		(2)	Input VAT claimable, tax invoice received	1	
		(3)	Input VAT claimable, with reason	1	
					3
	(b)	(1)	Output VAT on fringe benefit	1·5	
		(2)	Value equals allowed amount, VAT is nil	1	
		(3)	Output VAT on net of allowed value	1·5	
		(4)	Output VAT on market value	1·5	
		(5)	Advertising purposes	1	
			Output VAT calculated on consideration, so nil	1·5	
					8
	(c)	(1)	Wear and tear	1·5	
			Running expenses etc	0·5	
			Output VAT	1	
		(2)	Expense deductible, with reason	1	
		(3)	Expense deductible	0·5	
			VAT deductible	1	
		(4)	Recoupment of income	1	
			VAT deductible	1	
		(5)	Recoupment of income	1	
			Allowable expense	0·5	
					9
					20

		Marks	Marks
5	**(a)** Transaction 1		
	s.12C allowance, but at 20%, with reason	2	
	Paul Cooper a connected person, with reason	1	
	Calculation of recoupment	1·5	
	Calculation of gain	1·5	
	Transaction 2		
	No deduction for lease improvements, with reason	2	
	Building allowance, with reason	1·5	
	Lease rental, with reason	1·5	
			11
	(b) s.103(2) conditions	2	
	Conclude first two conditions satisfied	1	
	Commissioner can presume/taxpayer must prove	2	
	Argument re lack of finance	1	
	Counter-argument re availability of loan finance	2	
	Overall conclusion re application of s.103(2)	1	
			9
			20